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Concepts and Terminology of Business Income

Administration of Accountants' Practice

Federal Income Taxation

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The New York Certified Public Accountant

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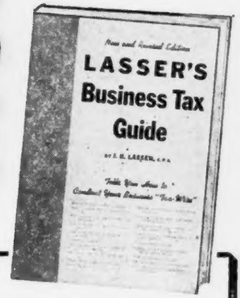

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THE NEW YORK
CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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VOL. XVIII — *January • 1948* — No. 1

A Restudy of the Concepts and Terminology of Business Income

By GEORGE O. MAY, C.P.A.

DISCUSSING in the issue of June, 1946, of the *Virginia Law Review*[1] the question what form the postwar developments of accounting were likely to take, I expressed the opinion that the answer depended largely on the future course of the price level, adding that accountants were more conscious of the accounting significance of changes in the purchasing power of the monetary unit than they were at the end of World War I.

Manifestly, a minor and possibly temporary change in the price level would not justify a reconsideration of the accounting practice of implicitly assuming the stability of the monetary unit (or perhaps agreeing to ignore its instability.) Moreover, economists in general hold that the beneficial effect on business of a steady and moderate decline in the value of the unit is sufficient to compensate for any loss of purchasing power of past savings which results therefrom.

GEORGE OLIVER MAY, C.P.A., is one of the country's most active thinkers and writers on accounting. He is author of many articles on the subject, as well as of the book *Financial Accounting*. He was senior partner of Price, Waterhouse & Co. from 1911 to 1940. He has been a director and president of the National Bureau of Economic Research, a vice-president of the American Economic Association, and is now a director of the Council on Foreign Relations. He has long been active in affairs of our Society and of the American Institute of Accountants, and has taken a leading part in the development of both the science and profession of accounting.

When I wrote the article the increase in open-market prices had already become pronounced. There were, however, even then reasons to fear that when controls were removed a rise in prices would occur which might be as great as the rise that look place at the end of World War I and probably more persistent. Some economists, such as Prof. S. H. Slichter of Harvard, suggest that the claims of labor are likely to go beyond those that can be met by increase of production and will have to be met by rises in the price level which will effectively reduce the share of total production received by those whose past savings have been invested in industry. Dr. H. W. Singer of Glasgow University has also expressed the view that "full employment long maintained is likely to be associated with an era of rising prices." As this is written, a newspaper heading says: "Union chiefs aim at third round

[1] This article was republished in the August 1946 issue of the *Journal of Accountancy*.

of increases since the end of the war."

It is not surprising, therefore, that the accounting profession today should feel compelled to restudy concepts of business income in the light of present-day conditions. It is obvious that in such a study the profession cannot well act independently but must seek the cooperation of leaders in other fields of activity in which accounts play an important part. The initiation of a research project to study the concepts and terminology of business income, under the sponsorship of the American Institute of Accountants and financed in equal parts by that body and by the Rockefeller Foundation, is a natural response to this need.

The Research Project which was announced in the August, 1947, issue of the *Journal of Accountancy* contemplates "a survey and a historical study of the uses of the word 'income' and terms associated therewith in accounting and in business, economic, and political fields." In asking support of such a study from the Rockefeller Foundation the Institute said:

> "It would seem not unreasonable to suppose that a fair measure of agreement could be reached as to the proper usage of the word when combined with a particular clarifying adjective. The exchange of ideas in the course of an attempt to reach such a goal would, in itself, be of great educational value. The report, it is contemplated, would afford a greatly improved starting point for the determination of such important economic issues as the relation between business income, as now commonly computed, and real 'ability to pay.'"

The research is an attempt to organize thought on problems of major interest to accounting on a broader basis than that of a single profession. It is inspired by the belief that accounting is utilitarian; that the determination of what is useful does not rest solely with the accounting profession and that the capacity of the profession to deal successfully with the problems that arise is necessarily dependent upon its ability to secure acceptance of its views by other parties interested. It is no part of the function of the research to lay down rules for determining income. If it affects accounting practice it will be only through suggestions which in due course will be considered by established committees of the profession.

The Research Group is a large one—about fifty in number—and includes not only accountants engaged in practice, administration and teaching but also lawyers, economists, bankers, financial analysts and representatives from the ranks of management, labor and Government. The acceptance of responsibility for the project by the Institute assures that the accounting point of view will be kept to the fore on the consideration of concepts of business income and the related terminology.

The project is a logical development of the course of action which began with the correspondence between the Institute and the New York Stock Exchange in the years 1932-1934. The second important step was the creation by the Institute in 1939 of the Committee on Accounting Procedure with an associated Research Department. That Committee considered the possibility of undertaking a study similar to that now planned but decided that the time was not then ripe. It decided that it could be more serviceable to the profession by undertaking a study of a series of single problems, leaving the broader task for later consideration and possible cooperative action. The time is now opportune for such a study because the developments of the last decade, particularly the changes in the price level, have emphasized the significance of the income statement and called into question the validity of some of the postulates of present-day accounting.

The object of this article is to suggest some points that the group will probably desire to consider, not to suggest conclusions which it should reach. It is a reflection of a personal willingness to follow the admonition of Mr. Justice Holmes to reexamine from time to time the first principles one has

accepted. It does not reflect the view of any firm, faculty, committee or group with which the author is, or has been, associated.

* * *

Attention is naturally directed first to the important issues raised by two documents that were published almost concurrently with the announcement of the Institute's project—a special Supplement to the Department of Commerce Survey of Current Business, issue of July, 1947, and the second quarterly income statement released by the U. S. Steel Corporation.

The Department of Commerce's publication contained a mass of information in regard to National Income which included an interesting analysis of operations of corporations for the period 1929-1946. Some of the more pertinent statistics contained in this statement are reproduced in an appendix to this article.

An estimate made by the Department placed corporate profits before income taxes in 1946 at $20.8 billions, taxes at $8.6 billions and profits after taxes at $12.2 billions. However, in working these results into its statement of National Income the Department made a downward adjustment of $4.7 billions as representing the amount of the profits reported which were represented in substance only by an increase in inventory valuations.[2] To this extent it estimated that profits were purely monetary and represented no real or economic gain. A comparison with 1929 showed that while the unadjusted figure indicated an increase of 50%, the adjusted figure showed a decrease of 13%. In passing it may be noted that the Department has not as yet made a similar adjustment in respect of consumption of plant in the course of production (depreciation).

The release of the U. S. Steel Corporation indicated that the corporation held depreciation based on cost to be inadequate provision for the exhaustion of property in operation under existing conditions and that it had made a supplementary charge on account thereof. In discussing this charge the release said "the principle involved is analogous to that applied by U. S. Steel since 1941 in the use of the "last-in, first-out" method of determining the cost of products and services sold in respect of inventories. However, the added amount for wear and exhaustion is not presently deductible for income tax purposes."

About the same time, the Institute's Committee on Accounting Procedure issued Bulletin No. 29 dealing with Inventory Pricing. This bulletin approved the use of LIFO as applying one of several assumptions as to the flow of goods, its position in this respect being in harmony with the language of the federal income tax law.

In the October issue of the *Journal of Accountancy* there appeared a statement by the Institute's Committee on Accounting Procedure in which it was pointed out that there was no accounting principle recognized today that sanctioned charges against revenue in respect of wear and tear on exhaustion of property not based on actual cost and that it was undesirable to adopt ill-considered and makeshift devices to meet problems growing out of the rise in the price level. In the same issue of the *Journal,* the Institute's Director of Research reiterating these points envisaged the possibility of developing new procedures which would do for capital assets what LIFO had done for inventories in making it possible to bring costs into account on substantially the same price level as revenues.

Thus, the Research Group at the moment of its inception faced the crucial question of the relation between (a) LIFO accounting as reflecting a reasonable assumption as to the flow of goods or costs; (b) LIFO as a means

[2] The adjustment applies mainly to manufacturing and merchandising corporations. Some of the industries more largely affected are noted in Appendix B, hereto, which also affords an indication of the importance of depreciation in different branches of industry.

of bringing costs and revenues into account on approximately the same price level; (c) the inventory adjustments to determine economic income made by the Department of Commerce; and (d) the new charge for plant exhaustion made by the steel corporation. The crucial importance of these issues is immediately apparent to anyone who follows the course of events in our country.

The President, in his address to the Congress on November 17th, making comparisons between 1929 and 1947 said: "In terms of actual purchasing power the average income of individuals after taxes has risen 39%." He also stated that "Industry is producing 65% more." At the same time he referred to current profits as "record-breaking."

The estimates of the Department of Commerce for the first half of 1947 indicated money profits at the annual rate of $17 billions. According to the Department's index, the purchasing power of the dollar of 1947 was less than two-thirds that of the dollar of 1929. But mere reduction of the $17 billions by one-third will not yield a comparison of profits for the two years in terms of economic gain. Steps such as the following must first be made to convert the charges against revenue to the same price level (1947) as the revenues:

Estimated profits as reported..............		$17	billions
Elimination of "profits" representing only increase in inventory valuations (Department of Commerce estimate).................	$5.3		
Adjustment in respect of plant exhaustion (say)	2.0	7.3	billions
Profits of 1947 in terms of 1947 dollars......		$ 9.7	billions

If it is desired to compare the purchasing power of this sum with that of the profits of 1929, an adjustment to reduce it by about one-third is necessary. This would leave the 1947 profits expressed in 1929 dollars at $6.5 billions. The 1929 profits in terms of 1929 dollars were approximately $8.7 billions. In the interval there has been an increase of more than 16% in population and, as already stated, an increase in production of about 65%.

From the foregoing figures it would appear that in terms of purchasing power the corporate profits per capita in 1947 were about one-third less than in 1929,[3] and the corporate profits per unit of production less than half that of 1929.

The question may well be raised whether present forms of reporting corporate income, which give no hint of these facts, present an adequate and significant picture or afford proper guidance when they are employed in the determination of national policies.

On this point, the comment of an economist writing to an accountant is significant:

> "The writing-up of the stocks, therefore, should be to a price changes account, not to the general profits account. To the economist it seems that the accountant who professes to be so cautious in refusing to take notice of unrealized money gains, rushes to the other extreme of recklessness in treating any realized money gain as true profit. The accountants have reaped the storm. The Inland Revenue authorities have accepted their proposition, and now when

[3] The picture is not changed if corporate dividends for the two years are considered instead of corporate profits. The Department's estimate of corporate dividends for 1947 of $6.5 billions would be equivalent to about $4.3 billions in 1929 dollars as compared with $5.7 billions of dividends paid in that year.

> prices are rising, taxation which is intended only to hit profits is in fact taxing a real part of the national capital. The fact that this habit of 'thinking in money' has accentuated the trade cycle in the past by imaginary profits in the boom and imaginary losses during the slump, may count for little in a postwar era of full employment. But the fact that the habit recoils on industry in times of rising prices should count all the more—full employment long maintained is likely to be associated with an era of rising prices."[4]

Dr. Singer's suggestion, that the writing-up of stocks (inventories) should go to a price change account, wakes a responsive echo, for the author has long argued that we need a new category of accounts in the proprietary section in addition to capital and earned surplus. We have escalator clauses in contracts to provide for changes in price levels. Perhaps we should, as Dr. Singer suggests, have escalator accounts in corporate books.

Meanwhile, some economics-minded management torn by conflict between its accounting and its economic conscience, and haunted by the admonition that "accountants would do well to consider whether they can help the economist in the preparation of statistics by providing more accurate and more informative accounts"[5] may find the solution of their problem in the fact that there is no form of presentation to which they are bound by either conscience.

We might then see a statement which would conclude somewhat as follows:

Income before income taxes on the basis of costs and revenues at the same price level................	X
Add—To bring income into accord with presently established accounting principles:	
In respect of inventories......................	Y
In respect of property exhaustion................	Z
Income before income taxes in accordance with accepted accounting principles..................	X+Y+Z
Income taxes..................................	—T
Net income after taxes..........................	X+Y+Z—T
Carried to special surplus reserve..................	Y+Z
Net income carried to earned surplus..............	X—T

Such a method of procedure seems to be suitable when it is desired to conform to existing standards and at the same time point the way to new and possibly more useful ones.

If the present price level is maintained, the effect of present accounting methods will be that there will have been reported as income, and subjected to tax as income, large amounts which represent no economic gain. To the extent that the price level falls there will be reported as reductions in income, or as losses, amounts which will not represent economic loss. If the fall in price levels were to approximate the rise that has taken place, the effects on industry would be disastrous and the corresponding relief from taxation would be inadequate even if the present provisions for carrying forward and carrying back losses for tax purposes were to be continued, which is perhaps doubtful. In any case, the effect of

[4] Dr. H. W. Singer to W. F. Sewell Bray in the latter's *Precision and Design in Accountancy*—Gee & Company, London, 1947, p. 119 and 120.

[5] H. Norris in the *Economic Journal* (London) December, 1944, p. 383.

the present methods is to swell income and tax revenues in times of prosperity and diminish them in times of adversity.

The Research Group might well study such questions as the following:

(a) Is there any reason to believe that the Department of Commerce is materially incorrect in estimating that reported corporate profits after taxes for 1946 and indicated profits for 1947 amount to roughly $29 billions and that over $10 billions of this total represent only a rise in the prices at which inventories were, or are being, carried? What steps could be taken to secure more accurate statistics on the point?

(b) If such an adjustment as is made by the Department, is necessary in determining the contribution of corporate profits to National Income, should a similar adjustment be made in respect of exhaustion and of long-term inventory items commonly called capital assets? If so, what steps should be taken to secure the information necessary for an adjustment?

(c) What are the social and economic consequences of regarding the taxing as corporate income an amount of which 20% to 30% (33⅓ to 50% after taxes) represents no economic or real gain?

(d) Is LIFO accounting, as now applied, only a reasonable assumption as to the actual flow of goods and costs or more broadly a means of bringing costs into account on approximately the same price level?

(e) If the broad view of LIFO is accepted, should accounting procedures be revised so as to bring the cost of property exhaustion into account at approximately the same price level as the revenues and, if so, how should this object be accomplished?

(f) Should the situation be met by changes in methods of accounting or by changes in methods of presentation or by supplementary information, assuming social usefullness to be the basic test of the appropriateness of accounting procedures?

This group of questions seems to the writer to be by far the most important that the Research has to consider. However, there are other important subjects for study in relation to the concept of income. One of them is the concept of the enterprise as the accounting unit. It is this concept that underlies the accounting introduced in the public utility field in recent years which calls for the carrying and amortization of assets on the basis of cost to the first person who devoted the property to the public service, known technically as original-cost accounting (though not all the applications of it). The use of consolidated accounts and the legal provisions relating to tax-free reorganization may also be regarded as expressions of this concept.

A postulate of accounting that might receive consideration is that which assumes the life of the enterprise to be indefinitely long. It is sometimes suggested that one of the merits of depreciation accounting is that it obviates reliance on this postulate but actually such accounting rests squarely upon it. For depreciation systems implicitly assume that the future life of the business will always be longer than that of any unit to which the accounting is being applied.

The one accounting proposal that involves rejection of the postulate which has been suggested in recent years is the compulsory amortization of goodwill. The attempt is sometimes made to justify amortization of the cost of general goodwill on the ground that the value of the particular asset acquired disappears after a relatively short

period but may be replaced by other goodwill as a result of expenditures subsequent to the original purchase. But the corollary to this somewhat fanciful concept would be that the subsequent expenditure should be capitalized which is not the present practice nor contemplated by the proponents. This brings us to another feature of accounting which merits examination, the disposition to distrust intangible assets (such as goodwill and the like) and to attach undue importance to tangibility, using that word in the accounting sense to include accounts receivable, securities, bank balances and other assets, which may be expected to be realized in the ordinary course of business.

This attitude in turn may be a result of the importance attached to "objective" evidence as a basis for accounting entries and of an unwillingness to attach weight to the motives which actuate expenditures. But lack of objective evidence upon which to base depreciation provisions has not prevented adoption of depreciation accounting. May not the development in the art and scale of publicity expenditures and the use of brand names have made the distrust of intangibles obsolete, and is there not a danger that the expression "objective evidence" may become a shibboleth instead of a useful criterion?

Still another postulate is the need of continuity in accounts. No one, however iconoclastic he may be, would question that continuity has a real importance for it is like double entry itself an essential part of the rigor which makes accounting superior to a collection of isolated statistics. However, there is sometimes a disposition to attribute to continuity an exaggerated importance growing out of the fact that it results in the availability of cumulative totals covering long periods.

The value of accounting records of the past diminishes rapidly as the period covered by them recedes. Cumulative, or rather residual, balances of earned surplus built up over several decades have little practical significance. It may well be desirable while preserving the rigor of continuity to reduce the emphasis on the value of the income account as a statement of the aggregate operations over a long period of years.

The subdivision of what is now the single account of Earned Profits to show separately profits from changes in price levels would add greatly to whatever significance the cumulative record possesses, especially if in long time tabulations of income the index of general purchasing power for the year was noted.

I would conclude this article by repeating what I said of financial accounts in the Dickinson Lectures of 1937:

> "They are accounts of happenings in a world of business which is subject to constant and sometimes violent change and full of uncertainties; naturally they cannot rise higher in the scale of certainty than the events which they reflect."[6]

[6] *Dickinson Lectures in Accounting,* Harvard University Press, 1943.

APPENDIX A

Trends in Reported and Adjusted Corporate Profits (A)

(In millions of dollars)

	Corporate profits after taxes (1)	Inventory valuation adjustment (2)	Corporate profits after taxes and inventory adjustment (3)	Purchasing power index (B) (1935-39=100) (4)
1929	$ 8,188	$ 472	$ 8,660	84.4
1930	2,318	3,260	5,578	93.1
1931	– 1,279	2,414	1,135	110.2
1932	– 3,390	1,047	– 2,343	124.1
1933	– 360	– 2,143	– 2,503	122.0
1934	917	– 625	292	107.4
1935	2,100	– 227	1,873	100.5
1936	4,169	– 738	3,431	99.6
1937	4,563	– 31	4,532	93.2
1938	2,042	963	3,005	102.3
1939	4,821	– 714	4,107	104.3
1940	6,213	– 148	6,065	102.3
1941	9,155	– 2,617	6,538	92.1
1942	9,208	– 1,274	7,934	81.5
1943	10,125	– 824	9,301	78.0
1944	9,635	– 355	9,280	77.3
1945	8,675	– 533	8,142	76.0
1946	12,223	– 4,689	7,534	67.2
	$89,323	–$ 6,762	$82,561	
1st 6 years 1929-34	$ 6,394	$ 4,425	$10,819	
2nd 6 years 1935-40	23,908	– 895	23,013	
3rd 6 years 1941-46	59,021	– 10,292	48,729	

(A) The figures shown in columns (1) through (3) were taken from "National Income," a supplement to the Department of Commerce Survey of Current Business for July, 1947.

(B) Index represents purchasing power of the dollar as measured by wholesale prices (Department of Labor). Average index for first nine months of 1947 is 54.1.

APPENDIX B

INVENTORY VALUATION ADJUSTMENTS AND OTHER STATISTICS

FOR SELECTED INDUSTRIES AND INDUSTRIAL GROUPS, 1946

	Corporate profits after tax	Undistributed corporate profits	Inventory valuation adjustment
	(Millions of dollars)		
Mining and contract construction....	585	373	– 104
Manufacturing	6,338	3,487	–2,831
Food and kindred products........	1,026	690	– 460
Textile mill products............	844	638	– 326
Chemicals and allied products....	837	449	– 247
Iron and steel and their products, including ordnance	738	424	– 349
Machinery, except electrical......	317	120	– 232
Miscellaneous	2,576	1,166	–1,217
Wholesale and retail trade..........	2,727	1,953	–1,544
Wholesale trade	1,096	808	– 712
Retail trade and automobile services	1,631	1,145	– 832
Transportation, communications and public utilities	1,235	310	– 211
Total all corporations	12,223	6,700	–4,689

SOURCE: National Income Supplement to Survey of Current Business, July 1947 U. S. Dept. of Commerce.

Distribution of Corporate Depreciation Charges by Industrial Groups, 1942*

	(Millions of dollars)
Mining and quarrying	163
Manufacturing	1,754
Public utilities	1,076
Trade	311
Service	154
Finance, insurance, real estate, etc...............	374
Miscellaneous	82
Total	3,914

SOURCE: Statistics of Income for 1942 Part 2.
* Latest figures available. Aggregate for 1946 approximately $4 billion.

Staff Training Programs

By Raymond G. Ankers, C.P.A.

The subject of staff training is an extremely important one. I believe you will agree that the reputation and prestige of every public accounting firm is largely dependent upon the integrity and ability of its staff. This dependence upon staff is applicable to all firms. Even though the principal of a firm maintains a close working association with a client, the client's opinion of the firm is materially influenced by the caliber of staff representatives with whom the client has dealings. Public accounting firms, being fully aware of this fact are willing to invest time and money to develop high-grade staff accountants.

Most large firms consider staff training, at all levels, of prime importance and have established training programs to meet this need. Although these programs vary widely in form and content, the purpose is always the same—the development of representatives who will reflect credit upon their employers in their dealings with clients. Of course, it follows that men having this training also benefit and their services become more valuable.

Raymond G. Ankers, C.P.A., is the personnel manager of Lybrand, Ross Bros. & Montgomery, C.P.A's., New York. He is a frequent author of articles on the subject of staff selection and training, and is a member of the Advisory Board on Occupational Guidance and Placement of Pace Institute. Mr. Ankers is Vice-Chairman of the Society's Committee on Education and a member of its Committee on Publications. He is also a member of the American Institute of Accountants and of its Committee on Education.

This paper was presented by him on October 31, 1947, at the First Annual Institute of The Georgia Society of C.P.A's. and The University of Georgia College of Business Administration.

Training, an Investment

In a sense, staff training is a speculative investment. However, the speculative characteristics will diminish and the investment will yield more gratifying returns if a training program is an integral part of a good over-all personnel policy. If the program is not coupled with good personnel practices, we are likely to find that turn-over in staff will be high and that return on investment will be low. In other words, the success or failure of staff training hinges upon a sound and well integrated personnel policy.

This raises two questions; first, what is a sound and well integrated personnel policy and second, why is such a policy necessary to make staff training a worth-while investment? These questions are fundamental to the entire subject and deserve our serious consideration.

The first question as to a sound and well integrated personnel policy is sufficiently broad in scope to permit substantial room for differing opinions. In my estimation such a policy contemplates:

1. Selecting beginners on the basis of their apparent potentialities to become supervisors or partners—not on their value at date of employment;
2. Employing beginners who have the same general scholastic background;
3. Employing staff members above rank of beginners for permanent positions only when these positions cannot be filled by promotions;
4. Having a definite training program to facilitate advancement;

5. Following closely the progress (or lack of progress) of all staff members;
6. Regulating assignment so that staff members will obtain experience in diversified lines;
7. Entrusting staff members with more responsible work when they indicate the ability to assume it;
8. Adjusting compensation periodically on the basis of ability and progress—not on length of employment;
9. Treating staff members as fellow professional men—not as clerical workers.

The foregoing which is necessarily brief is limited to those personnel practices which seem most significant in retaining well qualified staff members.

Now, we come to the second question; why is it necessary to have such a policy to make staff training a good investment? The main reason, of course, has just been stated, namely, to reduce the turnover in personnel. To express this in accounting terminology—good personnel practice conserves the assets behind the investment. The assets referred to are the trainees. If a large percentage of these trainees do not remain with their employer, the value of the original investment becomes questionable.

Reasons for Training

There are several specific reasons why large firms consider staff training necessary. Despite the excellent curricula in accounting and related subjects, which have been developed by colleges and universities, the student, even the accounting major having a fine scholastic record, is not ready immediately to participate in audit engagements. Beginners without previous business experience and those who have had some clerical experience require orientation in public accounting to bridge the gap between theory and practice. It is highly desirable that this is obtained before they are assigned to engagements requiring their presence in clients' offices.

We find that most beginners, including those who obtained degrees with an accounting major, are deficient in auditing knowledge and in the effective and proper use of English. The beginner who has had from four to six hours of auditing instruction, possesses a fairly good knowledge of auditing technic but unfortunately he knows immeasurably less concerning the applications or implications of that technic. During recent months I have visited a number of schools and have obtained the impression that greater emphasis is now being placed on the broader aspects of auditing. If this impression is correct we can look forward to the elimination of this deficiency in due course. In the meantime, staff training does materially benefit beginners in this connection. On the other hand, the time we devote to instruction in English is obviously inadequate materially to assist beginners having an insufficient background in this subject.

Staff training is also necessary at advanced levels to keep experienced men abreast of the constant changes in accounting and auditing practice, in Securities and Exchange Commission regulations, in tax laws, etc. Relaxation in training for experienced men could conceivably result in self-satisfaction or stagnation. Ours is a profession requiring constant diligence if we are to serve our clients well.

As important as any of the foregoing reasons given for staff training is what might be called a by-product of such a program. I refer here to the splendid *esprit de corps* which is engendered through the knowledge that the employer is manifestly interested in staff development and progress.

Training Beginners

Most large firms have well defined training programs for beginners. The methods pursued in administering these programs vary widely but basically they fall into one of three general classifica-

tions. For the purpose of this discussion I will refer to these methods as classroom, report department and on-the-job training.

As indicated, the classroom and report department programs contemplate training beginners before they receive assignments to audit engagements while on-the-job training does not. The first two methods differ mainly in the procedures followed and the time required for training. Before giving examples of these types of training programs, I wish to emphasize that training does not cease in the case of the classroom and report department methods when a beginner receives his first assignment. At this time he will commence on-the-job training.

The firm with which I am associated inaugurated a formal student training program of the "classroom" type at its New York office some twenty years ago. Since then we have conducted such a course annually except during the war and certain depression years when very few students were employed. We have had students from 52 colleges and universities in our training classes and 54 per cent of these men are still with the firm. We are rather proud of this record particularly because the period covered includes several depression and war years.

I would like to mention here that Mr. A. R. Jennings of our firm presented a paper at the recent meeting of the American Accounting Association in which he described our training program in considerable detail. His paper is to be published in the coming issue of the *Accounting Review*. May I also mention that any similarity between his paper and what I am about to tell you concerning our training program is *not* purely coincidental.

At the present time our New York office is conducting a training school which is being attended by approximately 30 beginners who are college graduates with an accounting specialization. Several of these men hold the master's degree. However, most of these trainees have had little, if any, business experience. This uniformity of background simplifies, to some extent, the instructional problem with which we were faced in 1946. Because of the special personnel situation created by the war, not all of our 1946 class were students in the usual sense. Although a high percentage of these students were college graduates their ages and business experience varied considerably. In this instance it was necessary to pitch our instruction at a level which would be most beneficial to the group as a whole—not too complicated for the inexperienced or too elementary for the more experienced men. Except for this difference in approach, our present class is following generally the program we used last year which I will now describe briefly.

Classes are held during working hours, five days a week for a period of eight weeks. During this period the students' entire time is devoted to classroom work and the men are not available for assignment to audit work. While no night work is prescribed by the instructor, most students indicate that they do considerable work on their own time. The program includes the following basic features:

- Audit practice case
- Lectures
- Talks by students
- C.P.A. examination review
- Mathematical problems
- Use of reference material
- Business machines

In addition, students receive a list of collateral reading material with which they are expected to become familiar including copies of the bulletins issued by the Committee on Practice of our firm.

Although our daily program is flexible, nearly every day some consideration is given to each of the above subjects except business machines. A typical day commences with a lecture by a member of the New York staff,

followed by supplementary comments by the instructor. After a brief intermission, the balance of the morning is available for work by the student on the audit practice set, C.P.A. problems or reference reading. On some days, however, no time is available for such study and research.

Immediately after lunch, one of the students gives a ten minute prepared talk on some phase of auditing after which he answers questions posed by the class and leads a discussion on the subject matter. Next, the class works one of the addition or other mathematical problems, and the day is completed with the instructor's discussion of a section of the practice set or part of a C.P.A. examination. The daily schedule is purposely flexible so that adequate consideration may be given to each point at the time it arises.

An audit practice set is the foundation for the course. We are using a recognized published audit practice set which provides case material for making a balance sheet audit of an industrial concern on the basis of assumed facts. Each student is required to make the contemplated audit and to prepare a long form report on the examination. The work material includes a complete set of books of account; specimen documents; information as to the accounting procedures and internal control of the client; instructions to students and, in some cases, copies of specimen working papers and audit report for the prior year. Each phase of the practice set is discussed by the instructor and amplified by technical lectures by staff members.

The working of this practice case, together with the supplementary comments and discussions in class, is designed to give students practical experience in the performance of an audit, including inquiry into the system of internal control, the development of an audit program, the carrying out of various audit procedures, and the preparation of a report.

Supervisors and experienced seniors are scheduled to present 28 lectures to our present class. An hour and a half of class time is set apart for these lectures, the presentation requiring about one hour and the question period about one-half hour. The subject matter of the lectures, where feasible, is illustrated with examples from actual practice and reference to actual working papers and reports. Starting with a general lecture on a subject such as the administration of an audit, the presentations cover—inquiry into internal control, audit programs, working papers, reports, audit procedures applicable to the various phases of an audit, income taxes, cost accounting, relations with clients, and audit problems of special types of engagements, such as banks, non-profit institutions, public utilities, investment companies, retail establishments, and mining companies. Whenever practicable these lectures are given at the time the subject matter is being considered in the practice set.

Lectures and discussions on conduct of staff members are particularly important. They should emphasize the importance of personal appearance, respect for confidential information of clients, and the proper approach to professional work. Of importance equal to technical auditing ability, is the ability to deal with people tactfully and maintain their respect and confidence. We try to impress upon students that differences of opinion may be expected to arise in practice and that the accountant should be able to present his case carefully, objectively, and convincingly. While it may not be possible to train staff men in the technique of getting along with people in business, sound advice and emphasis on its importance is of assistance.

Several of our partners also appear before the class and discuss various matters of a professional nature, such as public accounting as a career, professional ethics, historical background of the firm, accounting societies and their work and the work of partners.

We consider all of these lectures a

very important part of our training program. In addition to their instructional value, they also afford an opportunity for beginners to become acquainted with some of our partners, supervisors, and seniors and to obtain tangible evidence of the interest our firm has in the staff training program. I might also add that in some instances gathering the necessary data for these talks and presenting them serves as staff training for seniors.

Previously, I mentioned that in the limited time available for training we cannot materially assist beginners who are lacking in ability to express themselves effectively, orally or in writing. However, we do not overlook this very important subject. The short talks the students give before the class are criticized by both the instructor and class members as to the quality of the material and the manner of presentation. These talks on assigned subjects, not only give students experience in technical research, but also in writing and in speaking before a critical audience. Furthermore, throughout all classroom work we constantly endeavor to impress upon staff members the importance of the effective use of English so that they will take necessary measures to improve their ability in this regard.

After these beginners have completed the formal classroom training, unusual care is exercised in assigning them to audit engagements, and their progress is closely followed through the medium of personnel reports. These reports, which are applicable to all staff members up to the rank of supervisor, are submitted by a staff member's superior promptly upon the release of the staff member from the assignment which the report covers.

The following spring after these students have had approximately six months' experience, a refresher session is held. The purpose of this session is to review the work performed by these men during the winter, to point out the specific faults which have been observed, to bring them up to date on recent developments and to give them an opportunity to discuss any questions which have arisen during their assignments and which remained unanswered. Faults and criticisms noted on personnel reports are discussed with the group without identifying the individuals who occasioned the criticisms. If the reported faults had warranted such action, the delinquency had been discussed with the staff member involved when the personnel report was first received.

Later, I will tell you about training programs for experienced men but now, I would like to review the training practices for beginners used by other large firms. My comments concerning them will, of necessity, be rather brief. My knowledge of them is limited.

Another large firm using the "classroom" method has an intensive three week training program for beginners. One of the main objectives of its school is to drill the men in the firm's approach and procedures in conducting an audit. The instructors devote considerable time to the analysis of the more commonly encountered ledger accounts, to the preparation of working papers, to the consideration of internal control and its relation to audit procedures and to the indexing and cross-referencing of papers. Two other objectives, of at least equal importance, are the development in trainees of an inquiring attitude and an unwillingness to adopt or follow any audit procedure without understanding its purpose. In addition to those features concerned with developing and strengthening audit skills, beginners also listen to talks by staff men and partners relating, among other things, to the history and policies of the firm, accounting and auditing work in specialized fields, accounting releases of the firm, annual reports of stockholders and reports and statements for the Securities and Exchange Commission. This firm's training program also introduces the interesting and unique feature of having students compete for honor ratings in their class on the basis of outstanding work. The honor is

earned both for themselves and the offices they represent.

Having given two examples of the "classroom" method, let us turn to the report department method of training beginners. Prior to the war this method was used by a number of firms. Since World War II, however, a high percentage of beginners are veterans and they are reluctant to start their careers in a report department. These men, realizing that they have lost valuable time, are anxious to start field work without delay. Since they are older and more mature in judgment, the urgency to get ahead may partially offset the advantages younger men obtained through several months of training in the report department. Only time will give us the answer to whether or not this is true.

However, because of this condition, several firms have not as yet renewed their former practice of training men in their report departments but I am informed that they do expect to reinstate this program when younger college graduates become available. The time alloted to this type of training by different firms varies from a few weeks to a year.

As you probably know, it is generally the function of the report department to proof-read all reports. This includes comparing manuscripts with typed reports, checking reports for mathematical accuracy, comparing amounts which appear in the text of reports with corresponding amounts shown on the statements contained therein or with other sources, such as the prior year reports and working papers. The final work of the report department is to read the report in its entirety for grammatical errors and inconsistencies in text matter. The report departments of some firms are also intended to provide an independent check to determine that reports contain no errors in the application of accounting principles, insofar as this is possible from the reports themselves, and also to ascertain that the requirements of the Stock Exchange, the Securities and Exchange Commission and other governmental agencies have been met.

Although certain phases of the report department work may become monotonous, it unquestionably inculcates in the beginner the importance of accuracy in dealing with figures and of care in the preparation of both working papers and reports. During slack periods when beginners are not occupied with report department work, they receive instruction relative to field work, procedures and practices of the firm and other pertinent matters.

To this point, the training methods discussed have been of a formal type. On-the-job training is not. It might be called an informal or training-by-experience method. On-the-job training for both beginners and accountants at advanced levels is, without doubt, the most important training they receive. It follows, therefore, that no less consideration should be given to training of this type than to the formal ones previously described. Perhaps the ideal program is on-the-job training, supplemented by previous formal training, but this combination is not always feasible. Either with or without formal staff training, actual experience under the direction of well-qualified accountants is essential. By "well-qualified accountants", I refer here, not only to good technicians but to men who are also good instructors.

The keystone to a successful on-the-job training program is care in making assignments. As indicated, this matter of assignments relates both to the "trainer" and the "trainee". Supervisors or seniors under whose direction and guidance beginners are to work should be selected on the basis of their ability and interest in training men. The "trainer" should be fully informed concerning the scholastic and experience background of each beginner placed under his supervision. This "briefing", as we learned to call it during the war, should continue for at least the first year as the beginner

gains experience and is transferred from one to another of these men.

The type of engagement to which beginners are assigned should also receive serious consideration. It is highly desirable to rotate assignments so that they will obtain diversified experience under the direction of different supervisors and seniors. They learn in this way that there is more than one approach to problems of the same character and that records and procedures vary widely in different businesses.

Obviously, there is no fixed or even uniform on-the-job training method. Training under this method depends upon the nature of the engagement, the specific work to which the beginner is assigned and the accountant under whose direction he works. However, some rather general observations can be made. For example, the beginner should be encouraged to ask questions. He should receive specific instructions with reference to the work assigned to him and its relation to the engagement as a whole. He should be guided in his relations with clients, encouraged in his work and, of equal importance, his work should be the subject of constructive criticism. When he shows the ability to handle more responsible work his assignments should be varied accordingly.

Advanced Training

If the fundamental purpose of staff training is the development of men for top staff positions, it is manifest that a discontinuance of training at the junior level would negate this objective. The acute shortage of senior accountants at the present time is indicative of the need to attain this objective. I have talked with representatives of a number of the large firms and they all agree that this shortage will be eliminated only when men within their own ranks can be advanced to fill these vacancies. The reason for the shortage of seniors is fairly obvious. It is the result of having but few young men available for training for the period of approximately six years, immediately preceding and during the war.

There is considerable room for effective training between the junior level and that of supervisor or partner and although training in this area is generally less definite than the formal training provided for beginners, it is certainly not less important. As the staff member advances in ability, training and added experience become practically synonymous, and the method of training, basically, is resolved to careful supervision and personnel administration. Other forms of training in this area should be looked upon as collateral to on-the-job training rather than as substitutes.

Staff members and partners alike must keep informed concerning current developments affecting the profession if they are to go forward or even hold their present niches in the profession. Because of this, a staff member is encouraged to obtain a C. P. A. certificate as soon as he becomes qualified to do so. After obtaining his certificate he is urged to join and take an active part in a state society of certified public accountants and in the American Institue of Accountants. The National Association of Cost Accountants is still another organization brought to the attention of those who have a special interest in cost and management problems. By taking an active interest in the work of these and similiar organizations and reading their publications, staff men are able to keep abreast of developments in the field and broaden their acquaintanceship with others in the profession.

Staff meetings are another medium through which advanced training is given. Some firms follow the practice of having regular monthly staff meetings to discuss current developments or a selected subject relating to accounting matters or staff work. Generally such meetings are held after working hours. Other firms consider it more desirable to hold staff meetings only when it becomes apparent that a particular sub-

ject warrants this action. These firms believe that special purpose meetings are more effective than regularly scheduled ones. Such meetings may be called to consider research bulletins issued by the Committee on Accounting Procedure and the Auditing Procedure Committee of the American Institute of Accountants or they may be called to discuss general firm practices relating to a particular subject of current interest.

A number of firms arrange to have these meetings conducted entirely by staff members or jointly by staff members and partners. This is done primarily to encourage active participation and discussion by the staff, and it appears that such meetings are generally more beneficial for that reason than those conducted by partners. However, it is definitely desirable, if not essential, to have partners present at all such meetings.

Another method in common usage by large firms to keep staff members currently informed on accounting and related subjects, is the issuance of bulletins. Our firm has several series of these bulletins, one series relating to accounting practice and procedure matters, another to S. E. C. matters and others to tax matters, etc. Every staff member is provided with a copy of each bulletin. Collectively, these bulletins serve as a guide when questions of general firm policy arise. They also supply staff members with information which probably would not otherwise readily come to their attention.

When large firms find that they have too few men with adequate knowledge in a particular specialized field, such as banking, brokerage, department stores or mining companies, they organize training classes to remedy this condition. These classes differ from staff meetings in purpose, in manner conducted, in selection of personnel for attendance, in size and in time required to attain the objective. The best results are obtained when classes are limited to a maximum of 25 or 30 staff accountants having similar experience backgrounds. An instructor is appointed to conduct the class and a definite training period is decided upon in advance. The time required is governed by the subject matter to be covered. In some instances two or three evening sessions might suffice while in others a week or longer, during working hours, might be necessary.

Although there are various other means of training experienced men, time does not permit a more extensive discussion of this subject.

Conclusion

A staff training program is a long range plan for a competent staff at all experience levels. It is a means to an end. The end result is a staff of high-grade accountants who reflect credit upon their firm in all client relationships.

In a profession such as our, where the reputation of the firm and the staff is interdependent, the existence of mutual respect is essential. The co-operative spirit and interest engendered by staff training is a material factor in the attainment of this ideal.

Selecting and Screening Accounting Personnel

By Raymond F. Murphy, C.P.A.

My comments on the matter of selection and training of accounting personnel will apply particularly to the smaller firm. However, the objective in selecting personnel should be the same for the smaller office as in the large office: it is to bring into its fold the highest type of person available to the profession in recognition of the fact that the service any profession can render is largely dependent upon the quality and stature of its practitioners.

Today there is no doubt that the universities and colleges that provide adequate training are the best sources of accounting personnel. There is quite a problem, however, in screening and selecting the proper personnel. I feel that the research that the American Institute of Accountants has done in the field of personnel selection should ultimately prove of great value in selecting accountants. As you probably know, the American Institute of Accountants' Committee on Selection of Personnel has done quite some good work. The two principal problems are, first, to inform students about the profession and then, second, to develop facilities to assist colleges and practitioners in identifying students or applicants having substantial promise of success in the public accounting field.

The Committee has developed three tests, (1) a general intelligence test and (2) a level-one test that applies to the students with one year of accounting and (3) a level-two test for students who have majored in accounting. It appears that the use of the general intelligence test and the level-two test should prove very valuable in selecting personnel for a staff. I feel that such a plan of testing and screening could be used by the small firms as well as the large.

I think the small practitioner fights the element of time quite a bit in many matters of administration of his office. As our chairman put it, "They don't properly allocate time to their various duties, while the larger firms ordinarily have well organized personnel departments or a partner in charge of employment".

Another problem the smaller firm is now confronted with is the matter of competition for personnel with these larger firms. As we understand it, they are now sending men into the field at graduation time, or before, to contact the men in the top category of their classes. So, of course, we, in the smaller firms, are confronted with the necessity of taking what is left, unless we can find ways and means to attract them to our firms by selling them on the advantages of a small firm or, as we used to be able to do, by selling them on the idea that living costs are much lower in the small towns. But now upstate, at least in Syracuse, living costs appear to be nearly on par with New York City.

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This paper was presented by him on September 26, 1947, at the 14th Annual Conference of the Society, held at Saranac Inn, N. Y.

As I see it, the small practitioner must allocate time to interview and screen applicants properly and must use such tests as are available to determine whether or not these men will work out in the public accounting field. On the matter of staff training, I feel a small firm is confronted with the very same problem as the large firm, that is, to fill the gap between accounting schools and accounting training and actual practice. We, in Syracuse, have felt the need of a training program for quite a while; but again, it is a matter of allocating time and scheduling it to prepare adequate and complete training programs. In our firm, and I know in some of the other firms in Syracuse, we have given some thought to training programs but have not formalized them. This year, we have finally evolved a plan that we hope will work. It is a cooperative plan of the various firms in town and sponsored by the Syracuse Chapter.

What we propose to do is to utilize one of the current auditing textbooks as a basis for a training course. Our course will have to do with the practical application of auditing techniques, procedures and principles. We propose that each office will supply its staff members (who will attend the meetings) with a copy of the text. Assignments will be made in advance for study and review. At our meetings, we propose to have a staff member from one of the firms conduct the class. The objective of the meetings, of course, will be to indoctrinate these new men in the ways and means of applying the auditing procedures that they have studied and learned in school.

This will be our first real attempt at staff training in Syracuse, although I believe one office made some progress last year. I believe that staff training is a problem, and one to which we in the smaller firms must allocate time, in order properly to plan and execute an effective program.

Expanding the Accountant's Services and Practice

By Robert E. Staunton, C.P.A.

Our chairman said originally that the small accountant had the green light to go ahead; and I think that that means that there are many avenues in which he can expand. Then he limits me to ten minutes to try and describe these avenues!

Everyone of us has to do the things that the previous speakers have been talking about. When he starts a practice individually, he must, of course, be acquainted with the accounting and auditing procedures, tax laws, and so forth; and he must plan his own engagements.

Staff Training

As soon as he gets into practice and gets two or three jobs going, he finds that he needs help. Then he must select employees and, as soon as he selects employees, he has to start all over again.

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This paper was presented by him on September 26, 1947, at the 14th Annual Conference of the Society, held at Saranac Inn, N. Y.

He has to revise his planning of engagements so that they can be handled by employees. He has the problem of staff training. And then he has to revise his own supervision of engagements because, in the original analysis, he was supervising his own work and now he's supervising someone else's work.

Partnerships

And then, of course, he grows a little farther, and he finds that he needs more responsible persons at the top of his organization, and he gets into the problems of developing a partner and partnership agreements. Then, he has to go clear back to the beginning, revising the plan of his engagements; retraining his staff to some extent because of the new responsibility of the partnership; changing the method of supervision, because there is going to be a division of authority and responsibility since, of course, the new partner is going to take over part of it.

Promotion

Of course, when he gets all through organization, he has to have some time for recreation—a definite need from a business as well as a health angle—and he has to keep up-to-date on reading the literature of the profession. For instance, George May's story of the "Future of the Balance Sheet" should give us some thought.

How is he going to expand his service? I think that there are opportunities galore for the expansion of service, and I am sorry that I am not able to agree with our previous speaker as to the approach of the accountant to the business problems.

We *try* to get into the business problems of our clients and to give them

advice where we can give it. In our organization we try to have someone aware of business problems. In our small organization, we confined that job of giving clients advice to the partners.

Why Discuss Expansion

I think that one of the reasons why many accountants don't cross over into the business advice field is that they have so many specific accounting engagements that they just don't think or try to get over into the other field. Their experience is limited by the fact that they never tried. But don't forget that there was a day when everyone of you couldn't walk, and you had to try; and then after many trials you walked. Now, if we can take the problem of a client, which we ourselves see, *even though the client may not have expressly asked us to study the problem,* we can study it from the standpoint of a businessman; put ourselves in the other man's shoes; apply our knowledge of business and our particular knowledge of his problem (which is probably greater than his knowledge of it) and our broad point of view, which is attained by serving many clients; and we can give better thought, more constructive thought, to the solution of the problem. We can also learn as we solve.

Preparation

I wonder how many of you have ever read Dr. Frederick Sheldon's papers on constructive selling? In these papers Dr. Sheldon tries to teach us to sell *ourselves;* and, among other things, he makes a particular point of teaching us to "Give and then Receive". In other words, he tells us that we must put a little coal on the fire and then turn on the drafts and we will get more heat. We can't just tell the fire to give us more heat and we will feed it more coal. Likewise, with the client, we can't just say, "Give us some problems and we will give you some solutions." It seems to me the way to attack the broadening of our experience and of our ability is first to solve some problems that the client may not even have noticed, and then to bring the solution of the problems to him; he will be glad to pay for the solution, if it's sound. After we have solved a few problems for a client, there will be points where we can help him, and shortly after that he will begin to ask us for help in fields in which we don't at present work. Thus, we can accept his assignments, solve his problems, and broaden our business.

Tradition

I think that the tradition of our profession is somewhat of a handicap in stepping over in this new direction, but I firmly believe that we should step that way. I think that Mr. May's story of the balance sheet is a step in that direction—to try to make the balance sheet more intelligible to outsiders. And I think that's definitely one of our problems—to study his method; to improve, or modify his method; to learn how to use it. Take the client's figures and set them up in the form that Mr. May suggests, and review and criticize until we are fully aware of what he is trying to do; and then, maybe, we can take some of these figures to clients and show them how the revised statement gives a clearer picture than the former set-up.

In making a change in accounting procedure, whether it is in the method of doing the work or in the method of presenting the statements, we must be careful to continue our comparative statements in the old form for at least a year after we make the change, submitting statements in both forms to the clent so that he can compare backward with the old methods and can utilize the new methods to tell him more about his business. Each of us has to take time out to do the broadening necessary to get over into this field. In fact, I am sure that many of you do now find it profitable because you are in those fields.

Operating Reports

The balance sheet is one place where we can improve ourselves; the operating statement is another place where we can make definite improvements and make them reasonably fast. For instance, the operating statement should be more indicative to the client of what his business management methods are accomplishing. We should make our statements, for instance, comparative and frequent.

We, in our organization, don't stand on an annual statement. We try to give our clients, and most of our clients do have, a monthly operating statement, analyzed in such detail that they can understand what is happening to them. And we try to get those monthly trends to stand out by producing a charter picture of 12 months' sales.

There are many other methods of statistical and graphic presentation of information. We had a discussion, for instance, before the Rochester Chapter, lead by a statistician whose business it is to present information graphically. He showed us how he could present 23 years' balance sheets and 23 years' operating statements on one piece of paper and make them intelligible, make them understandable, and make them show trends, and to show in many cases why those trends were occurring. We must be careful when we get into the field of statistics that we present the picture soundly, and I think that that takes some business judgment, some knowledge of business in order to be sure that we are presenting it. I think we must have that judgment and must use it. I think we must analyze, on occasions, the cost systems of our clients; not just cost analysis but a study of the basic system. That is more nearly true accounting than it is business management, but it will lead us to better business management. Too few of us, I believe, even get into the analysis of basic methods. I think that if we are offering good business advice to our client, we can sometimes analyze the reports which pass between departments and the reports which go to executives and produce some information that will simplify or clarify those reports.

Sometimes we can assist in simplifying and clarifying reports which go to stockholders and employees. I am very favorably inclined to the use of some graphic presentations in the balance sheet and operating statement. I think we do have a specific job to perform in improving the balance sheet and operating statements so that they are understandable to the users.

Special Services

I can only speak from experience, but I can tell you that we are at present assisting in the negotiation of a union contract, and I think that that's an accountant's job. The union is asking, in this particular case, for more than the client thinks he can pay, and it is our problem to find out how we can balance that down to what the client can pay and satisfy the majority of the union demands. We have had problems on real estate—Should a client buy or rent? Possibly he is renting—Should he buy the building? Should he buy it himself or should he have a subsidiary corporation buy it? Or, possibly, if he is operating as an individual —Should his wife own the stock in the corporation which buys the building? These problems come up and they have to be discussed from the standpoint of tax saving, and they also have to be discussed from the standpoint of business utility. There are always possibilities to watch both from the tax and the business angle. The question of proprietorship or corporation is, I think, a specific problem which should be one of our targets. The methods of incorporating are problems of the attorney and we must be careful not to encroach on the field of the attorney; but the principles back of proprietorship or corporations are our problems—Is the corporation or the partnership the best method of doing business for this particular industry?

We can't draw the agreements to make a partnership or to incorporate a company, but we can plan what those agreements should do, what they should accomplish, determine the amount of capital involved, and advise the prospective investors how to go about it, recommending that they see their attorney. We've had clients come in and ask whether they should invest in a business or not. That requires an analysis of the balance sheet and the operating statement, the study of what the business has before it, and that is not just historical accounting; that is forward looking business counseling. The sale of a business, the dissolution of an unsafe partnership, the replacement of officers, those are all things that we can get into. We have even gone into another field, where we have found unsatisfactory results in a department, and have pointed to those results and assisted in making changes in supervision which would correct the condition.

Even the planning of a client's will can be partly our problem. Recently, where a client had planned a certain disposition of his property, we studied it not only from the tax angle, but from the business angle. What would happen after his death? How well could others carry out his objectives? Then, of course, he took the matter to his attorney and had his papers drawn. So much for specific problems, the first part of the subject—the expansion of a practice and services.

I think there is plenty of green light ahead for us if we'll look for it and if we'll learn to do business counseling.

Public Affairs

The participation in public affairs, which is the second part of the subject assigned me, is one in which I am vitally interested. Each of us, everyone of us should be on a civic committee of some kind in our locality. In Rochester I think that we have a history of a Certified Public Accountant appearing only once or twice on a mayor's committee on any problem. We should be in a position where we're asked to do some of this committee work, and you can't get into that position by asking the mayor. You have to accept jobs in other fields and eventually show your worth. And when that worth is demonstrated, I think we can participate and I think we will be asked to participate, and I think it will be to the benefit of the profession and ourselves.

The question of membership drives, for instance in the Chamber of Commerce—I think that is a field in which we should work, not to locate clients but to get out and work for the benefit of the town and the Chamber of Commerce and the profession. And I think it is a benefit to the profession and will help the profession and it can help each of us that gets into the work. With respect to committees in the Chamber of Commerce—there are quite a number of jobs that need attending to there, and need strengthening by the addition of C.P.A's. The Committee on Business Trends in Rochester is one in whose activities I participate and I enjoy it very much and get benefit from it.

Education

The Syracuse Chapter is doing something in the training line, as Ray Murphy told us, and I want to mention something that we are trying to do which I think is in the nature of a public service, although it is not going to reach the whole of the public. We are holding a meeting next May on the subject of "Training for Accountancy" and our program is developed to the point where we will have, we hope, the top accounting men, that is, the supervisors of the accounting training work at the University of Buffalo, the Syracuse University and the University of Rochester on a panel before our group for the purpose of studying the educational methods used in accountancy training in the three universities. We had a similar panel last May in which only a representative of the

University of Rochester was present. During the discussion and later after the meeting, we discovered that there are organizations which had established specific auditing training programs based upon the use of the books of bankrupts secured from Referees and other sources. We are not aware of how to get hold of those books, but we have a man in Rochester who is connected with a firm that has done that, and we're asking him to lead that panel and to try and get some books that would be beneficial to the University of Rochester and which we can present to them at the time of this meeting as laboratory equipment for the study of auditing. Our University is seriously considering adding a fifth year to its accounting courses for the study of auditing, and our opinion in Rochester is that it will be a good thing for the University and for us when the students come out. We think that's a good thing for us to get into. We think that it is a public service and we're going into it.

Summary

Our chairman has pointed out that there are many fields in which we can work and that the green light is on, and that we can go into these fields wholeheartedly and with benefit to ourselves and the profession. I have tried to discuss some of those fields, even though they are somewhat distant from the accounting field. Then I have tried to point out that public service in the Board of Trade, the Chamber of Commerce, or other local civic bodies, together with appearances before various groups including clubs and service organizations, will be beneficial to ourselves and to the profession. I have also tried to emphasize the fact that we have a specific interest in the education of the boys who will be the accountants of 1960 and 1970, and that we should get into that field and help the universities and educational institutions to do a better job than they are now able to do, so that our profession may continue to grow, expand, and uphold and improve its high standards in the future.

An Expanded Concept of Accounting Services

By John T. Murray, C.P.A.

PROFESSIONAL accountancy originated as an adjunct to large scale capitalism and its growth in the past century has been largely contemporaneous with the emergence of the complex entities and far flung activities of modern commercial enterprise. In the simpler economic society theretofore existing, the functions of recording and interpreting the events that took place in the daily affairs of a business were delegated to clerks or assumed directly by the proprietor. There being little need for anything more than a historical record of these events and memoranda of amounts owing, amounts due and assets on hand, there was little necessity for a professional class to assist in the undertaking. Thus, there were only a handful of individuals who held forth to the public a specialized knowledge of recording techniques, and who were prepared to interpret and to verify records prepared by others.

The need for the public accountant arose when ownership became severed from management, necessitating the interposition of an independent third party to protect the financial interests of a multitude of investors, and when business activities expanded, both in volume and intricacy, to a point where the limited training and perspective of privately employed bookkeepers were no longer fully equal to the task of supplying complete, accurate and authentic information to those who owned and managed the enterprise.

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While accountants have made their greatest strides, and have achieved recognized professional status in the service of large corporations, the smaller business represents a field of activity into which they have scarcely ventured. This statement may, at first glance, seem paradoxical, since the recent high tax years have witnessed an unprecedented demand for accounting services from all strata of business. However, the paradox resolves itself when it is considered that this increase was not attributable to an awakened understanding of the potential value of the accountant as a general business counsellor, but was largely due to an intensified demand for the same kind of service which had theretofore been rendered, namely, preparation of tax returns and, less frequently, review or audit of books and records.

The continual narrowing of the scope of free enterprise through governmental regulation and governmental participation in profits by way of taxes, together with the quickened tempo of competition, has made it imperative that the business owner or executive minimize consideration of operating details and confine his efforts to those vital matters upon which the success, or even continued existence, of the business depends. In so doing, he must bypass the multitude of special problems of a relatively minor importance which, nevertheless, are increasing as busi-

ness becomes more closely bound to government and to the demands of society.

These factors have given rise to the need for a type of professional service which might be described, for want of a better phrase, as "business counselling." The need for such service has already been noted and provided for in large concerns by development within the organization of a corps of specialists. Thus, there are experts in insurance, taxation, accounting, credit, real estate and many other fields, whose function it is to render advice to top management in matters pertaining to their respective specialties and, consequently, to relieve those on a policy forming level of the necessity for acquiring a detailed knowledge of these auxiliary activities. In smaller business identical problems are presented in minature and there is frequently no one but the harassed proprietor, or sales and production conscious corporate officers, to give them attention and resolve them to best advantage.

It is at this junction that the public accountant can render a real service to the business community and, at the same time, immeasurably enhance his status as a professional adviser. By broadening the scope of his service to include consideration of these technical matters, he can, in effect, provide a comptroller-treasurer service to organizations too small for a full-time financial officer and can achieve something of the professional intimacy with his clients' economic affairs that is enjoyed by lawyers and physicians in those matters within their respective spheres of activity.

Several questions may well arise in relation to the nature and practicability of these added responsibilities which accountants are being urged to undertake. In the first place, it is quite obvious that the public accountant is not, and never will be, as well equipped to give advice on questions of insurance, investments, governmental regulations, and so forth, as specialists in these fields. It is certainly not the intent of this article to intimate that accountants can lay claim to omniscience in all economic matters and replace the highly specialized advisers in various economic fields. On the contrary, it is merely urged that the public accountant undertake consideration of the broad implications of these matters in the same sense, and with the same degree of skill and understanding that would be expected of him were he the financial officer of a business organization, devoting his entire time to a single company's affairs. It should be his duty to study the broad outlines of the problems as they arise, to resolve those he can, and to recommend to the management the employment of specialists when the need for their services is indicated.

This expanded concept of accounting service may be tangibly illustrated by a comparison of the handling by public accountants of a few representative items with the treatment which would ordinarily be accorded such items by a full-time financial officer.

Workmen's Compensation Insurance

The usual approach by public accountants to workmen's compensation insurance consists of determining the accuracy of prepaid and accrued amounts at periodic intervals, vouching the bills and other supporting documents, and determining that refunds have been properly recorded in the accounts and have not been diverted from the client's funds by fraud or error. A broader treatment would encompass verification of the correctness of the manual rates and classifications used by the insurer, a detailed check of the computations made by the insurer in arriving at the periodic charges, and investigation of the various possibilities for savings, such as executive

salary exclusions and limitations, self-insurance plans and segregation in the accounts of overtime premium pay from overtime at straight time rates. It would not involve preparation or trial of cases before the Workmen's Compensation Board or suggestion of major changes in the compensation insurance program without the advice of an insurance consultant.

In an actual instance, inspection of the insurance company invoices and comparison of the classifications used against the rate manual resulted in material savings to a client. The plant was engaged in welding and machining work and the productive labor force was about evenly divided between welders and machinists. It was noted that the insurance company classified all productive workmen as welders, and that the rate per $100 for welders was approximately twice that for machinists. The client's insurance agent was advised of this and a substantial refund was secured. In another instance, it was discovered that several company executives having incomes in excess of $25,000 a year were being included by the insurer in its office and clerical payroll classification at their gross salaries. The terms of the policy provided that officers could be entirely excluded from coverage, under certain circumstances or, if included, the premium was to be computed on a maximum salary of $5,200. This, together with other less flagrant discrepancies noted, resulted in a substantial refund and a lowering of annual compensation insurance costs. In this case, also, the client's insurance counsellor was advised of the facts and the steps necessary to secure the refund were taken by him. Other instances might be cited, but those set forth above serve to illustrate the extent to which the public accountant's services may go, in situations where there is no qualified financial officer. They also indicate the limitations which should not be transcended.

Taxes

Recent confiscatory tax rates have made tax practice one of the most vital phases of professional accountancy. However, the usual engagement calls only for preparation of income tax returns, since federal and state income taxes constitute, in most cases, the major portion of the governmental tax exaction.

There are numerous other taxes which are customarily treated in a perfunctory manner, and which, in many instances, might be considerably reduced, or even eliminated, if given careful consideration. Numerous illustrations might be described in which material savings have been effected in New York City General Business Tax, Federal Documentary Stamp Taxes, and other minor levies. However, the nature and extent of the proposed services in relation to these taxes may best be illustrated by analogy to the present handling of income taxes — computation of the liability based on careful review of the applicable law and regulations and determination of the correctness of the figures employed.

In addition to consideration of the minor taxes, a complete advisory service should contemplate research into tax avoidance methods. Two tax studies recently made by the writer, at the request of clients, were on the formation of a Western Hemisphere Trade Corporation and the establishment of one of the deferred compensation plans which are currently being publicized by some of the larger life insurance companies. Both of these subjects have potentialities for effecting material savings in income taxes, under certain circumstances, but to determine whether the qualifying circumstances are applicable to a specific taxpayer requires a thorough knowl-

edge of his business, as well as of the tax law, interpretative regulations and court decisions. Such work can only be undertaken where the engagement is sufficiently broad to permit the accountant to recognize the possible applicability of the plan in question and to determine finally whether its tax-saving potentialities warrant its adoption. Once again, the function of the accountant ceases at this point. The Western Hemisphere Trade Corporation should be formed with the advice and consent of the client's attorney, whose opinion should be sought on possible disadvantages from a legal viewpoint which might vitiate any tax-savings that would result. A deferred compensation program should be initiated with the guidance of an insurance counsellor or a recognized specialist in pension trusts.

The limits of responsibility set forth above are substantially equivalent to those customarily assumed by a privately employed treasurer or comptroller and, when undertaken by the public accountant, will provide smaller business concerns with all of the benefits derived from the services of a financial officer at a cost in keeping with the size of the organization.

It is possible to analyze and compare the present and proposed treatment by public accountants of every balance sheet and income statement item encountered in the average business. However, direct analogy to the well known functions of privately employed financial officers, together with the specific comparisons heretofore cited, are, it is believed, sufficient to point out the duties and delimit the responsibilities of the "part-time comptrollership" or, more aptly, "business counselling service" proposed for public accountants.

If it be conceded that such a service is both practicable and desirable, the next questions may very well be: "How can clients be advised of the accountant's value as a business counsellor? What, specifically, can be done to convince clients that this added responsibility is justifiable and will result in material benefits to them?"

Although the expansion in accounting service discussed in this article has been denominated a "business counselling service" for purposes of clarity, no such clean-cut delineation is desirable in practice. Development of this type of service can be effected by tangible instances of savings realized for the client and by valuable suggestions put forth voluntarily by the accountant. One or several examples of the value of his advice will lay the groundwork for more frequent visits, with the object of more intimately concerning himself in the client's affairs, and will enable the client to measure, in dollars and cents, the pecuniary benefits that will accrue to him if he utilizes to a fuller extent his accountant's capabilities.

The favorable impression created by savings on workmen's compensation insurance taxes or similar matters can be developed into the pervasive financial responsibility which accountants should strive for and which they are ideally equipped to assume.

Problems in Assuming Proper Responsibility for Public Accounting Engagements

By Max Block, C.P.A.

During the past fifty years (the lifetime of the New York State Society of Certified Public Accountants) there has been a prodigious growth in business, both in numbers as well as in the size and complexity of organization and operations. Paralleling this development was the progressive integration of our economic system with our political and social systems. These evolutionary phases have set the pace for the vast growth of the accounting profession and for the progressive establishment of higher standards and improved auditing and accounting techniques. Certified Public Accountants have become such important adjuncts to business and to governments that they have acquired a position of vital importance and trust as well as social significance.

The accounting profession will continue to grow and increase its importance only so long as it satisfactorily carries out its trust and responsibilities, and only so long as it continues to improve its facilities for service to its employers, the business of this country, and to the governments and the public at large. This applies equally well to the individual practitioner.

There have been criticisms levelled at accountants individually and collectively from within and without. Some of these criticisms arose from misunderstanding on the part of credit grantors and investors as to the accountant's role, the scope of his audit, and the meaning of his report or opinion. To overcome this condition, accountants' organizations have been carrying on an educational campaign to clarify the points of misunderstanding.

There are, however, criticisms which appear well founded, and which crop up with a frequency and regularity which is disturbing. These complaints deal largely with deficiencies in audit scopes and reports. It should be possible by bringing into the limelight the problems which require attention, to bring about a steady improvement. A noteworthy move in this direction was taken by the American Institute of Accountants on December 20, 1946, in a letter to its members pointing out specific criticisms of audits and reports which had come to its notice. It is the purpose of this discussion to review the facts and authoritative opinions regarding the obligations of accountants in engagements of small and moderate size.

Accountants are in an unusual position, different from most other professions and vocations, in that though they are engaged by their client, their services and reports are relied upon by third parties in business dealings and investments. This is the factor that bedevils the subject of accountants' responsibilities. It has been established by court decisions that there is a responsibility to third parties where gross negligence in performance can be established.

However, our sights must not be set so low as to just hurdle the barrier of

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legal culpability. We should conform with the self-imposed rules established by the profession, through its associations, which fix the highest level of performance that is practical and consistent with the engagement. We must also take all reasonable precautions that our reports do not unwittingly permit assumptions to be reached, by a trained or untrained statement reviewer, which are not consistent with the facts. For example, any statement on an accountant's stationery or in a report cover bearing his name has an implication of authoritativeness, regardless of remarks therein to the contrary.

Approaching the subject of responsibilities more directly, the first point to be observed is that they are initially fixed by the nature of the engagement, and secondarily borne out by the audit and report. For example, many engagements are continuous monthly audits leading up to the year-end audit, and are intended solely to inform clients on the operations of a month or other interim period, and the apparent financial position. In these instances inventories are stated as submitted by the clients and other assets and liabilities are not independently verified. Such reports are entirely proper and serve a very useful purpose. But, there should be some definite reference to the limitations of the audit and the statement.

Such limitations may be imposed in several ways and it may, in instances, be desirable to utilize more than one in the interest of safety. For instance, the report letter should contain a reference to the effect that the examination was interim in nature and that assets and liabilities were not verified independently, and that the inventory, if any, is stated as submitted. This disclosure may also be made in a footnote to the balance sheet, to this effect:

> "This balance sheet has been prepared without verification of assets or liabilities by direct correspondence or inspection, and the inventory reflected therein is stated at the figure submitted by the management."

Still another form of limitation is used by some practitioners. It is a rubber stamped or printed legend on the main, or all statements, and schedules, of the report, containing the following, or similar statement:

> "This interim statement, subject to the customary year-end verifications and adjustments, has been prepared from the books for the information of the management only and is not to be used for credit purposes or public information."

The employment of such disclosures should nevertheless not be construed as a license to disregard other minimum requirements. Where a statement is prepared without audit, or such limited audit as to be equivalent, its submission on the accountant's stationery or in his report cover may convey an implied indorsement. In these cases accountants would do well to submit the statements on blank paper and report cover, and without the usual letter of transmittal signed by the accountant.

In any event, where a monthly or other interim report is submitted on an accountant's stationery, and where credit grantors, trade groups, or other third parties will, directly or indirectly, have access to the figures, then, regardless of the qualifications contained in the report, a reasonable minimum audit should be made. Such minimum audit requirements were recently listed by Stephen Chan, C.P.A., in a paper presented at a public meeting of the Committee on Monthly Audits and the suggested procedures will be referred to in a later section.

Where the interim report includes comparisons, statistics and other data which may not have been verified, or which are stated as submitted by a principal of the client company or by the bookkeeper, some reference should be made to the source.

With regard to year-end or annual audits, whether or not interim audits

have been made, the problems are somewhat different. Here the accountant should rise to his greatest height, because this is usually the most important report furnished the client and the one most likely to be circulated amongst, and most carefully analyzed, by bankers, credit men, stockholders, and other third parties.

Good practice calls for the observance of the following rules with respect to annual audits and reports:

1. The minimum audit requirements specified in the pronouncements of the American Institute of Accountants, the State Societies of Certified Public Accountants, the Securities and Exchange Commission, and other such authoritative sources should be observed. It does not matter how small the engagement may be; if a Certified Public Accountant is to submit his opinion and affix his signature to a report, the audit should measure up to the generally recognized standards.

2. If a required procedure is omitted, disclosure thereof, together with the reasons, should be made in the opinion. Where the omission is of such seriousness as to negate an opinion, then none should be stated.

3. If an opinion cannot be expressed because of a major omission, then a statement should be substituted to the effect that the extent of the verification was not sufficient for the expression of an opinion, because of the deficiencies noted. The statement should be carefully worded so as not to deprecate the audit and report unduly.

4. Every report which is unrestricted for third-party use, including the long-form report itemizing the audit procedures, should contain an opinion, or the substitute just referred to, where necessary.

At this point it is timely to refer to two recent articles on the subject of accountant's responsibilities by I. B. McGladrey, C.P.A., which should be read by all Certified Public Accountants and reread. The first appeared in the Journal of Accountancy (November, 1946, issue) and the second appeared in the Accounting Review (July, 1947, issue).

One reference therein touches aptly on the need for conclusiveness in a report, to wit:

> "I do not see how any ethical practitioner can conscientiously defend the practice of merely stating what verifications were made and which were omitted, thus leaving it to the third party to decide whether the scope of the examination was sufficient for him to depend on the report."

The omission of opinions is unduly prevalent. This condition may be due, in large measure, to the difficulty accountants encounter in expressing a conclusion where, for example, nothing was done about checking inventory quantities or evaluations, because of the client's objection or unwillingness to pay for the service. In such cases the accountant should strive to convince the client of the importance of this step and emphasize the effect its omission will have on the report. This is not a hopeless task, as Mr. McGladrey points out.

The final aspect of the problem of accountant's responsibilities might be referred to as the legalistic phase. Mr. Saul Levy, C.P.A., in an article entitled "Accountants' Liability", which appeared in the October, 1942, issue of *The New York Certified Public Accountant* emphasized the importance of the audit scope where opinions are expressed. The following point was made therein:

> "The scope of the examination made is so essential a prerequisite for the expression of the opinion which is founded upon it, that from the standpoint of legal liability the examination and the opinion usually merge into each other."

While the accountant's responsibility to third parties, as settled in the *Ultramares* case, developed only

if fraud is proved, the Court's opinion is here quoted as to what constitutes fraud:

> "Even an opinion, especially an opinion by an expert, may be found to be fraudulent if the grounds supporting it are so flimsy as to lead to the conclusion that there was no genuine belief back of it."

This further remark is also noteworthy:

> ". . . that negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross."

In conclusion, the following thoughts are expressed as an aid in minimizing the occurence of the criticisms discussed: The initial arrangements with a client for an audit and report must be soundly planned and carried out. The client should be advised as to the minimum audit requirements which have been promulgated by accountants' organizations for the benefit of business. In this connection, the use of tests and samplings should be explained so that if defalcations or errors later come to light, the accountant's position will not be misunderstood.

To demonstrate the authority for his position, if necessary, it would be wise for the accountant to be armed with pamphlets such as the following:

"Examination of Financial Statements by Independent Public Accountants"—issued by the American Institute of Accountants
"Statements on Auditing Procedure"—issued by the American Institute of Accountants
"What Does an Auditor's Certificate Mean"—issued by the American Institute of Accountants
Other material, including credit agency publications and magazine articles.

Last, but not least, the fee should be satisfactory. Where the set fee is clearly inadequate an audit may suffer. This is not fair to the client, because there should be no deviation from good practice because of the inadequacy of the fee.

Returning to the minimum audit steps which Mr. Chan specified, as warranted even where no certificate or opinion is expressed, and in all cases where a statement is released on the accountant's stationery, the reader is referred to the full length article which appears in the October, 1947, issue of *The New York Certified Public Accountant,* on page 656.

Business Appraises the Public Accountant

By Edward P. Klingenmeier, C.P.A.

Last fall when the chairman of our program committee invited me to participate on this panel he stressed the point that what was expected and desired was a frank criticism of the ways in which public accountants and auditors conduct themselves in their everyday contacts and relations with their clients and in representing those clients in matters pertaining to taxes and other external affairs. So what I shall say in this paper might very well be entitled "Pet peeves pertaining to public practitioners".

The invitation sounded very alluring, it was just like having someone hand me a bag of over-ripe tomatoes and saying "we'll stand up here, now see how many times you can hit us". I couldn't turn that down and I thought there wouldn't be the slightest difficulty in pulling dozens of peeves out of the bag to throw at you. When I got to working on it though there weren't nearly so many honest-to-goodness, justified criticisms as I had anticipated. However, there was a surprising repetition of several of them from different businessmen and private accountants with whom I talked, and I shall try to pass along to you tonight those which seemed most general and most annoying and irritating.

"Good Lord! Are those auditors in again?" That expression perhaps best exemplifies the attitude of the accounting personnel in many of your clients' offices. Why? You ask? Well, I don't think there is anything personal in that reaction. Possibly some of your staff men haven't paid sufficient heed to the Lifebuoy ads or to those for Listerine or Kolynos toothpaste. But, I don't think that accounts for the reaction. Neither do I believe it is accounted for, in most instances, by any apprehension or fear of what the auditor may find in the way of errors, omissions or other discrepancies.

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I think that probably in the great majority of cases the reaction is generated by a feeling of impending disruption of the more or less even tempo of the office routine. It is a feeling somewhat akin to that you get when you look out of your window to see your mother-in-law stepping out of a taxi with enough luggage to hold her over for several weeks. You don't dislike the dear lady, but you know darn well things aren't going to be the same while she's there. And so it is with your client's office help—they know things aren't going to be the same while you're there. However, a little thought and consideration may go far towards alleviating that feeling.

If your client's office is limited as to desk space (and show me one that isn't) his accountants probably shudder at the thought of crowding over on one-quarter of the desk while the auditor spreads out reams of paper and stacks of ledgers and journals and camps on the other three-quarters for the duration. Such an arrangement isn't exactly conducive to a spirit of friendliness and cooperation. What to do about it? Well, that should receive consideration when preliminary arrangements are being made. Obviously, it is the client's responsibility to provide suitable accomodations for your staff, but unless he knows in advance how many auditors are going to descend upon him he has no opportunity to make proper provisions for them. In making the preliminary arrangements the client should be consulted as to how many of your staff can be accommodated with his usual facilities and whether it is possible to provide additional desk space if required. If it is agreed that the maxi-

mum number which can be accomodated is, for example, three or four or five, don't decide at the last minute to send out a couple of extra men just because they're available for a day or two. Stay within the limit and things will go much more smoothly.

There is another common peeve closely related to overcrowding your client's desk space, and that is, the use of his mechanical office equipment such as adding machines, calculators and so forth. I don't propose that you should provide your own equipment and have your men carry them along on each assignment, but I do believe that your use of the equipment of the client should be kept to an absolute minimum and should be arranged so as not to interfere with the regular routine of the accounting department. By way of illustration, if the client's adding machine is regularly used early in the day for listing cash receipts it won't help matters for one of your staff to decide at that time to start running a tape of outstanding checks. With a little preliminary questioning you can undoubtedly ascertain what times of the day the equipment is regularly in use and your men should be instructed not to interfere at those times. It hardly seems necessary to add that at no time should any piece of equipment be appropriated to your prolonged use without the permission of the person or persons who will thus be deprived of its use, and of the head of the department.

Would you like to have someone go through your working papers, disarrange them, and mark them up unnecessarily with large and important looking red, blue, green and other varicolored check marks? No? Well, it seems that's what often happens to the client's records when your crews get busy on them. It is recognized that as a general rule some kind of marking is necessary to indicate what has been checked or otherwise verified, but when the check marks are made so large and prominent that they assume more importance and attract the eye more than do the actual figures it's time to call a halt. Check marks, when necessary at all, should be as small and inconspicuous as possible and should be so placed as not to interfere in any way with figures already posted, nor with the space where subsequent postings are to be made. No less irritating to many of your client's accountants is the careless attitude that some auditors take in handling the books and papers comprising the accounting system. Perhaps this is not so common a peeve as some of the others I mention, but in spite of what you may think to the contrary, there are some accountants who take pride in the neatness and orderliness of their records, and a little extra care on the part of your staff in maintaining that condition may go a long way toward creating a better feeling of friendliness and goodwill. Certainly no auditor can afford to overlook or ignore any opportunity to build up goodwill in the hearts and minds of his client's staff. It might prove to be an interesting experiment in applied psychology the next time you run into one of these meticulous cousins to see what his reaction will be to a greater effort on your part to humor his virtue, or his idiosyncrasy, whichever way you look at it.

Another common complaint of those with whom I have discussed this subject was that some auditors seem to have very little appreciation of the fact that the accounting and office force of the client are obliged to keep up their regular work and duties while you are there. They complain that frequently during the day they are interrupted by the staff man with some more or less trivial question. One thing which will go far toward preventing this undesirable aggravation of the tempers of your clients' personnel, particularly those in the higher-up level, is to try to arrange for short question or discussion periods—a fixed time most convenient to the client, when the accumulated matters may be brought up and answered or explained. This will not only be less annoying to the company's employees and officers, but in

most instances will be more satisfactory for you as well.

Another point much along the same line as the last, has to do with the continuing assignment to any audit of the same personnel, or at least the same supervisor or senior-in-charge, whenever that is possible. Sometimes conditions may arise which make this impossible or perhaps you're a staunch advocate of the old theory that rotating assignments tends to keep the staff men on their toes and also tends to prevent over-friendliness and excessive familiarity between auditors and auditees. But, consider the unhappy plight of the client's staff which every year or two has to "break in" a new auditor on that particular accounting system. A senior or any other staff man who has been on an assignment for a few years will naturally get to know the ropes and will be able to avoid undesirable interruptions to your victims (excuse me, your clients) with repetitious questions about their system and procedures. I don't mean by this that there should be no changes in the crew assigned to any audit, but it is desirable to repeat enough men to form an experienced and informed nucleus.

Some of those with whom I talked said they thought that auditors are inclined to make too numerous and detailed analyses and transcripts of the client's accounts and records and they felt this was unnecessary waste of time and, of course, an unnecessary accumulation of per diem fees. That's a tough one to answer and I won't attempt to tell you what you should or should not include in your working papers insofar as excerpts or analyses or transcripts are concerned. Certainly that is as much a matter to be decided according to your best professional judgment, or the exigencies of the particular engagement, as is the question to what extent you will use test checks or to what degree you will rely on internal control. It is your duty and responsibility to make such examination as you deem proper and essential in order to pass upon the accuracy and reasonableness of the recording and reporting of the results of your client's business transacations as they are reflected in the accounting records and the statements prepared therefrom. The only suggestion or advice I could possibly offer on this point is "Let your conscience and your professional integrity be your guide".

I would like to offer as a final word a sort of parody on a well known and oft quoted quip—you can please some of your clients all of the time, and you can please all of your clients some of the time, but you don't please all of your clients all of the time. To the extent that you measure up to the first two of those you will probably grow and prosper in your profession, but if you suddenly awaken to find you have been guilty of the last one and have lost the goodwill and esteem, as well as the business, of one of your clients as a result of what may seem to you trivial and inconsequential frictions or, perhaps, even unwarranted gripes it will be too late to mend your fences.

Your clients and their personnel are only human; they react favorably or unfavorably as you please or displease them. If you expect to continue to enjoy their favorable consideration you must not only sell them your services, but you must throw in, gratis, the very best that you can offer in the way of courteous and thoughtful consideration and cooperation. You are prohibited by ethical standards from advertising your services or soliciting business in the everyday commercial sense, but there certainly is no prohibition against your striving to make such a favorable impression upon your clients and others whom you meet professionally that they will always carry in their minds a thought something like this: "That fellow, John Blank, the C. P. A., seems to be a fine chap, he is not only a crackerjack accountant, but he goes out of his way to be pleasant, cooperative and unobtrusive when he's on the job. He's the man I would recommend to my friends who need an auditor or tax accountant".

Supervision and Review of Accounting Engagements in a Small Firm

By Robert P. Schermerhorn, C.P.A.

Supervision and review of accounting engagements is a broad subject, and any comprehensive analysis would require more time than has been allotted at this session. It is probable that my assignment can best be accomplished by a review of basic thinking behind the problem, rather than by a detailed study of what might be required in any particular situation.

Supervision and review is considerably harder, in my opinion, in a small firm than in a large firm. In the large firm, there are several levels of personnel, many of whom are doing some supervision and some review work. In the larger firm, the staff accountant makes the examination in the field under the supervision of a well-trained and well-seasoned senior, who is probably again supervised by a more experienced man, and so on up until the examination comes into the office where it is reviewed by trained reviewers and then receives its final review from a partner. In a small firm, this must be done in all of its stages by relatively few people. It is possible that the principal himself, in some cases, would make the entire audit, if it is a special one, even if he has a staff. He must, of necessity, do a review and supervisory analysis of his own work. It is exceedingly difficult to supervise and to evaluate properly work done by oneself. In any event, in the small firm, the principal must be concerned with the actual accounting and auditing functions and also must think objectively of the engagement as it progresses in the several stages.

The beginning of supervision and review of an engagement, as I see it, occurs when the staff man in charge of the engagement is assigned to the job. He should be acquainted with the scope of the examination, what has gone before, the peculiar problems to be faced, and perhaps a review of the prior year's work. With the aid of the principal, he should prepare the audit program and should get off to a well-organized start. If properly begun, the supervision is well under way. During the actual engagement, the principal will undoubtedly visit the staff man at the client's office to do some supervisory work, which normally would be taken over by a supervisory employee in the larger firm. He will be reviewing that work as he goes along, subjectively; that is, he would be reviewing the details as they progress. He is examining with the staff man the actual details and is making no attempt, at that particular point, to take a look at the whole problem. He must determine, or assist the staff man to determine, the scope of the examination, and the adequacy of the verifications. He must be equipped to answer questions or aid the staff man in an analysis of any special problem that may arise. He will undoubtedly be the liason between the client and the staff, and discuss the examination at various stages with the

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client. That is part of the supervisory work during the engagement itself.

When the finished examination comes into the office, there then must be two kinds of review, as I see it. One, a subjective, analytical and critical review of the engagement; the other, an objective study of the whole audit and examination that has been made. It would seem to me that the perspective of staff and supervisors would be broadened by suggesting that they conduct the audit and prepare the report as though it were being issued and signed by them. If the staff senior can be convinced to do the job as though he were going to sign it himself and take full responsibility, his thinking processes have been aided. In addition, if he will make a complete review of his own work, the principal will be aided in making the review, because he has the full benefit of the thinking of the senior.

I believe that the principal should try to review the audit, first, without the staff man being present, thus making the working papers themselves stand up as documents that will survive intensive scrutiny. If it is possible, to convince the staff man to prepare papers with the thought in mind that this particular sheet may someday be Exhibit A in a court action, and that it must be in sufficient detail with adequate explanation so that it will stand the test of being torn apart in cross-examination or be interpreted by a layman, then much will have been accomplished. If any error in this direction should be tolerated, it should be the error of making too much of an explanation. Eventually, the man will find what is adequate, but in the beginning he should learn to tell too much rather than too little. Many times the explanation that is very conclusive to the man making the examination cannot be interpreted by anyone else.

The principal should, of course, examine the worksheets, the supporting schedules, the analyses, and the criteria of proof that have been used. He should also examine the adjusting entries in detail, and the situations which necessitated them. What he is doing at that phase of the review, as I see it, is to re-audit the audit. He is making test-checks of the completeness and accuracy of the result of the engagement. In bringing the staff man in for an oral review at this point, the principal would undoubtedly ask him: What do you mean by this? How do you know? What proof do you have? What have you looked at? Can you convince me that it is so? Can you convince an outsider?

I think the principal point in this review is, first, whether or not there is a sufficiently comprehensive verification under the circumstances; the principal should be the judge of whether or not it is sufficiently comprehensive. His greater experience should be the guide at this point. Are the assets conservatively valued? And are they clearly stated? Do they tell a story in themselves? Are necessary or enlightening footnotes included? Are all the liabilities provided for, not only the direct liabilities, but the contingent liabilities? Do the schedules intelligently present the results of the audit? Are all the various analyses, qualifications, explanations, schedules, etc., present in support of the final report that has been prepared? This usually would complete the subjective examination of the audit and report.

The principal must then do what is very often done only by the reviewing principal in a large firm, namely, sit back and take a look, not at the "trees", but the "forest"—and objective look. It seems to me that a Certified Public Accountant, in working with a client during the year, should attempt to protect that client in every ethical way. He is hired by the client, and is trying to help him, whether it is in connection with taxes or any other business problem that may arise. When the annual examination begins, the relationship changes materially; the principal must bear in mind that others are interested in the examination and report, such as the bank, the credit bureaus, and all

others who may ultimately receive the report.

At this point, I think the principal must review the report from the viewpoint of the outsider and put himself in that frame of mind. What does the report tell such a person? Have his problems been taken into consideration? What can he determine from it? Is there sufficient information to give him the facts on which he can grant credit or do the various things that may be required of him? Has the principal, in all cases, stated what he means to say? Has he stated any and all exceptions or qualifications clearly?

After the report is reviewed from the viewpoint of the outsider, it should be reanalyzed from the viewpoint of the client. Has he received the proper consideration? Was the report overly harsh? Did the auditor bend over backwards to protect everyone but the client who relies on him to present an independent and fair statement? The principal must not protect himself against possible repercussions from an inadequate examination by a too conservative report which might do the client considerable harm. Proper supervision will give the principal adequate facts from which he can prepare a fair report. If these facts are not available, he should continue the examination until a fair report may be presented.

As a final thought, the principal should make sure that he has stated his conclusions professionally, and in a way that will do credit to him and to his firm; that he has expressed himself properly, if you will, wherever he does take exceptions or make explanations; and then he should review the report to see that he has done an overall job. These things are done in a large firm by several people, while in the case of a small practitioner, they must usually be done by one man. That is what makes his problem more difficult.

Some Notes on Audit Working Papers

By OTTO A. SHULTS, C.P.A.

Preparation

WORKING papers are papers on which compilations, analyses, and memoranda are made by or for accountants, which later are used as a basis for reports, exhibits and schedules, or for the preparation of tax returns upon which the accountant is working.

The accountant in setting up his working papers really demonstrates the extent of his accounting theory and accounting knowledge. His character and habits also, in my opinion, are reflected in his working papers. The skill of an auditor, his appreciation of good methods and orderly procedures, may also be judged therefrom.

One of the fundamental duties of our profession is to bring out and disclose careless methods in others and to recommend proper accounting methods, when necessary. Neat and orderly working papers are an indication of the accountant's own habits in this connection.

Accountants should set up as a part of their office procedure some method of proper instruction of junior accountants as to the manner of setting up working papers. When an accountant is assigned to an engagement, it is necessary that he use his judgment as to what information or data his papers should contain to support the report that he is to compile. He must be alert and must be able to grasp quickly the extent of the essential information he should have in his files. It has been said that faulty working papers are directly due to indefinite audit programs or instructions.

Working papers should be very carefully selected. They should be of proper, standard size, proper color, so that working thereon will be easy on the eyes; they should be of good quality and should provide appropriate spaces for headings and data to be recorded thereon. Every sheet of the working papers should be headed with the client's name and an appropriate description of the subject matter. Working papers should be legibly written, in pencil or ink.

In setting up the working papers, the accountant should be governed by the nature of the work and the program laid down by the accountant in charge, taking into consideration the type of report that will be required by the client. I believe it is safe to say that nothing should be written and preserved that is not expected to be of future value. It is necessary, however, that all matters presented in the text and schedules of a report be supported in the working papers. In compiling the working papers, it is more important to set forth a record of the steps taken in verification than it is to record detailed figures that may be obtained from the permanent records of the client.

In many instances, it is sufficient to record summaries of accounts as taken from the client's books instead of recording all of the detailed information. Working papers should contain schedules covering points for future follow-up, as well as memoranda relating to criticisms, suggestions, and correction of errors.

The auditor should keep in mind that his working papers will serve several purposes, such as the preparation of the

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text and schedules of the audit report; the preparation of tax returns; the starting point for the next audit; etc.

Each sheet of the working papers should be initialed and dated by the accountant performing the work. It is important that they contain all schedules and analyses required for the purpose of determining balances in accounts and to bring out the appropriate explanation of what an account really consists of.

In many cases, it is necessary for the accountant to obtain exact copies of documents, such as agreements, by-laws, etc., so that his working papers will be complete. In such cases, photocopies should be obtained, if possible, and all copies made should be properly authenticated.

The working papers should not only contain the accountant's conclusions, but also the facts upon which the conclusions are based. They should contain all questions raised during the examination and the manner in which they were disposed of. They should contain notes of all conversations with officials and with the client or his representatives, in connection with the examination.

Every schedule comprising the working papers should contain a memo as to the source of the information. The source may be a ledger, book of original entry, voucher, paid check, letter, contract, or some other written instrument. Or it may have been obtained orally from the client. Depending upon the subject matter and its importance in relation to the assignment undertaken by the accountant, I believe it is necessary that oral information, given by the client, be confirmed in writing by the client, or should be written by the accountant upon the working papers in ink and signed by the client.

All important details in support of the accountant's conclusions should be set forth. Clarity and sufficiency should not be sacrificed to save time.

In the case of small or large assignments, it is essential that working papers be kept, for the reason that the examination may extend over several weeks or months before being completed. Work undertaken by one accountant is sometimes completed by another. Unless working papers are complete, confusion will result, work will be duplicated, and the accountant has nothing in his files to support the report.

It is very important that working papers contain full information regarding all items, together with the method of verification adopted for each, for the following reasons:

1. Working papers are the connecnection link between the client's records and the audit report.
2. Working papers contain the accountant's evidence of the correctness of the report.
3. Accountants may be required to submit their working papers should legal controversies arise in connection with the audit report, or in connection with other matters relating to the client's financial transactions.
4. Working papers are the accountant's main defense should his work be criticized.

Working papers after being completed by the accountant in charge should be reviewed. The reviewer should also initial and date the sheets.

Filing and Preservation

During the course of an audit program, working papers should be filed in such a manner that ready reference may be made to the various matters in progress.

I believe that during the course of an audit, working papers should generally be filed in the same order of the accounts in the balance sheet and income statement, or in the order as recorded on the trial balance. After the working papers are properly arranged, they should be prefaced by an index. Some auditors find it convenient to use the trial balance as an index, placing the number of the working paper opposite the trial balance item to which it applies.

After being arranged in the index, audit working papers for a particular engagement should be bound. The practice of filing loose working sheets in an envelope should be condemned, as one sheet might be removed and replaced in the wrong folder or lost. In binding working papers, a heavy backing should be used as a cover. The cover should contain essential information such as the name of the accountant, the name of the client, period covered, file number, etc.

I believe it is essential that working papers for small engagements as well as working papers for larger engagements be divided into what are known as current and permanent files. The current file, containing all information regarding the current audit or examination; the permanent file, containing information that is continued and will be used in future audits, such as instructions, information pertaining to capital assets, some agreements, such as leases, by-laws, abstracts from the minute book, a copy of the Certificate of Incorporation, schedules of capital assets and reserves for depreciation, and other information that is more or less of a continuing nature.

Working papers should be filed alphabetically or given a number in a numerical file, and should be kept in a fire-proof vault or cabinet. It is the usual custom, I believe, for accountants to retain working papers for two or three years in the auditor's office or in a place readily accessible to them. Thereafter, the papers may be filed in a fire-proof public warehouse or some other place where they will be accessible and protected. It has been the practice of my firm and, I believe, of many practicing Certified Public Accountants, never to destroy working papers for clients who are actively in business.

The micro-film process is easily applicable to the accountant's working papers. If this method is used, the storage space requirement will be greatly reduced. Whether or not it is practicable in a given case depends on the use that is made of such working papers by the accountant.

We are called upon often to refer to working papers for essential data that a client may require, covered by audits made 30 or 40 years ago. Our audit files were used many times during the years 1917-1930 in tax cases where it was necessary for the client to substantiate invested capital for excess profits tax purposes. During the past seven years, it has frequently been necessary to obtain from our files information supporting transactions that occurred as far back as 1885.

I believe that it is essential that each case be carefully reviewed as to the length of time working papers should be kept before any papers are destroyed. I believe that many firms keep all of their working papers for a period of at least ten years.

Recent Trends in Reorganization Cases

By BENJAMIN HARROW, C.P.A.

THE first cases that reached the Supreme Court involving reorganizations were decided against the taxpayer.(1)

In these cases the taxpayer argued that the receipt of stock of one of the parties to the reorganization in the exchange of securities was like a stock dividend that the Court itself had at about that time held to be a nontaxable dividend.(2) But the Court found that the exchange involved a distribution of the surplus akin to a property dividend and the exchange was held taxable as an ordinary dividend to the extent that it was in effect an ordinary distribution of the surplus.

Soon thereafter Congress adopted provisions in the law making exchanges in connection with a reorganization non-taxable. These provisions were highly technical but they offered a method of distributing or absorbing a surplus without subjecting it immediately to a tax as an ordinary dividend. Under the impact of high tax rates in recent years taxpayers have been loathe to declare dividends and it was to compel more adequate distributions that Congress introduced Section 102.

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A taxpayer can minimize his tax on surplus distributions if he can convert such a distribution from ordinary income into a capital gain. This has always been available to a taxpayer if the distribution could be construed as a liquidating dividend. So to minimize taxes on growing surpluses the taxpayer could dissolve or reorganize. To prevent liquidations or reorganizations that were mere matters of form and that were too obviously meant to be distributions of surpluses as capital gains instead of ordinary income, Congress introduced two special provisions in the law.

The first is Section 112(c)(2) which provided that if a distribution of other property or money by or on behalf of a corporation in the course of a reorganization *has the effect* of the distribution of a taxable dividend, then there shall be taxed to each distributee as a dividend, such an amount of the gain recognized on the exchange as is not in excess of the distributee's ratable share of the undistributed earnings and profits of the corporation. Only the remainder of the gain is taxed as a capital gain.

The other is Section 115(g) which provides that if a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner

(1) *U. S.* vs. *Phellis*, 257 U. S. 156 (1921); *Cullinan* vs. *Walker*, 262 U. S. 134 (1923) *Rockefeller* vs. *U. S.* 257 U. S. 176 (1921).

(2) *Eisner* vs. *Macomber*, 252 U. S. 189 (1920).

as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent that it represents a distribution of earnings or profits.

These two provisions have been powerful weapons in the hands of the Treasury Department in resisting the attempts of taxpayers to distribute surpluses without subjecting such distribution to tax as ordinary income. The Courts have supported the Commissioner in several important cases.

Consider first the *Bedford* case[3], decided in 1945. In this case the corporation effected a recapitalization which, of course, qualifies as a reorganization. The taxpayer pursuant to the plan of recapitalization exchanged 3,000 shares of cumulative preferred stock of the Abercrombie & Fitch Co. of a par value of $100 for 3,500 shares of cumulative preferred stock of a par value of $75, 1500 shares of common stock and $45,024 in cash. In prior years Abercrombie & Fitch had paid stock dividends totaling $844,100 which were charged to the surplus account in these years. It had a deficit of about $400,000 for the fiscal year ending January 31, 1937, and it had a net profit of about $309,000 for the current year. But because of the over all deficit, it could not under State law pay dividends.

On the basis of the fair market values of the old and net stock, there was a gain of $139,740 on the exchange but under Section 112(g)(1)(d) of the Revenue Act of 1936 the gain would be taxable only to the extent of the cash received. The issue was whether this gain is to be taxed as ordinary income or as a capital gain. The Court held that there was a distribution under Section 115a out of accumulated earnings and profits and that this had the effect of a distribution of a taxable dividend under Section 112(c)(2) even though the distribution was made pursuant to a reorganization.

It would appear from this decision that any distribution of cash or property which constituted part of a corporate reorganization is taxable as an ordinary dividend to the extent that there are sufficient earnings and profits to cover it.

In *Abraham Kirschenbaum* vs. *Commissioner*[4] this was held to be the rule for distribution in connection with the redemption of stock. There would appear to be no difference between the reorganization provisions where the question is whether the distribution of earnings "has the effect of the distribution of a taxable dividend" and the redemption rule where the question is whether such a distribution is "essentially equivalent to a distribution of a taxable dividend". In the *Bedford* case the Court makes the observation that perhaps all cancellation or redemption of shares will be taxable as dividends where there are accumulated earnings and profits.

In June of this year the Supreme Court extended the rule in the *Bedford* case to a situation where an exchange of securities in a recapitalization involved the receipt of debenture bonds. No cash was involved. In *Bazley* vs. *Commissioner,*[5] one of the cases, the stockholders exchange old common stock of par value $100 and for each share received 5 new shares, no par, but at a stated value of $60 and new debenture bonds payable in 10 years but callable at any time.

The contention of the stockholders was that the transaction was a tax free reorganization, that the debentures were securities in a corporation a party to a reorganization, exchanged solely for stock or securities in such

(3) 325 U. S. 283 (1945).

(4) 155 Fed. (2nd) 23 (cert. den.) (1946).

(5) 67 Supreme Ct. 1489 (1947).

corporation, in pursuance of a plan of reorganization.

The Circuit Court[6] and the Tax Court[7] decided the case against the taxpayer but it emphasized the fact that the recapitalization had no legitimate corporate business purpose and it looked for a time as if a new element was going to be introduced in the reorganization provisions: a distinction between corporate business purpose and business purpose of the stockholders. The Tax Court had ruled that the distribution of debentures was a disguised taxable dividend under 115(a) and (g). The Supreme Court avoided any such distinction. It made several significant observations. Justice Frankfurter who also wrote the opinion in the *Bedford* case said at one point:

> "In the case of a corporation which has undistributed earnings, creation of new corporate obligations which are transferred to stockholders so as to produce for all practical purposes the same result as a distribution of cash earnings cannot obtain tax immunity because cast in the form of a recapitalization."

At another point he said:

> "It is not the purpose of the reorganization provisions to exempt from tax what as a practical matter is a realization of gain. Nothing can be recapitalization unless it partakes of those characteristics of a reorganization which underlie the purpose of Congress in postponing tax liability through such reorganization. Here there was the appearance of a reorganization to accomplish a distribution of earnings."

It is significant that the Court also sustained the tax under Section 112(c)(1) by treating the debentures as the receipt of other property or money and not as securities. Naturally, the *Bedford* case was cited. In the *Adams* case[8] there was also an exchange of stock for stock and debentures. As "boot" the debentures would of course be taxable under this section if there was a gain on the exchange. But in this case there was a loss on the exchange and section 112(c)(1) is not applicable where there is a loss. In this aspect of the case Justice Frankfurter would seem to be in error. As a bookkeeping detail the surplus account showing accumulated earnings was left unchanged. The debentures that were issued had a value about equal to the surplus. The Court nevertheless taxed the issuance of the bonds as a distribution of an ordinary dividend.

In the above cases the taxpayer presumably attempted a distribution of surplus in the guise of a reorganization. In a case decided by the 8th Circuit Court of Appeals on July 28,[9] the taxpayer discovered to his dismay that the Court read into a dissolution of a corporation and the organization of a new corporation, a reorganization, even though the customary form required in the reorganization provisions was not followed. The purpose of the liquidation of one corporation and the organization of a new corporation was to enable the stockholders who owed money individually to convert their personal obligations into corporation obligations. Under Missouri law, a corporation cannot assume individual obligations. The stockholders thereupon dissolved and liquidated the company. The assets acquired by the stockholders were then conveyed to a new corporation and the new corporation issued its promissory notes and stock for the assets received. The new corporation without interruption continued to conduct the identical business previously conducted by the old corporation.

The taxpayer claimed a capital loss on the liquidation. This the Tax Court disallowed on the ground that the transaction was not a mere liquidation but a reorganization under 112(g)(1)(d).

In addition, the new corporation

(6) 155 F (2nd) 237 (1946).
(7) 4 T. C. 897 (1945).
(8) 67 Sup. Ct. 1489 (1947).
(9) *Survaunt* vs. *Commissioner,* CCA 8, 1947.

claimed a stepped up basis for the depreciable assets. This too the Commissioner disallowed on the ground that the assets were acquired in a reorganization and the predecessor's basis for the assets should have been used.

The Tax Court had found that considering all the parts of the transaction together and not separately, the liquidation was only one step in an integrated transaction; that by means of the entire operation there was "transferred" under 112(g)(1)(d) by the old corporation all or a part of its assets to another corporation and immediately after the transfer the transferor or its shareholders were in control (80%) of the stock of the new corporation under 112(h). The stockholders acted as a conduit for the delivery of the assets.

Of course, the taxpayer contended that the form of the transaction did not meet the requirements of the statute and that there was no corporate purpose; which latter fact was even one of the findings of the Tax Court.

The Circuit Court ruled that the transfer of assets of one corporation to another through an intermediary would satisfy the requirements of Section 112. This the Supreme Court had decided in *Helvering* vs. *Alabama Asphaltic Limestone Co.*[10] where there was a transfer in bankruptcy of assets of an old corporation to its creditors and by them to a new corporation. This constituted a reorganization. Furthermore, the Circuit Court held that this finding of the Tax Court was binding on it under the *Dobson* rule.

Of course the proposition that the reason for the transaction was found by the Tax Court to be personal as opposed to corporate presented a serious question and naturally the taxpayers relied upon the *Gregory* case[11], and the Circuit Courts' opinions in the *Bazley* and *Adams* cases. But the Circuit Court held that the motive of the stockholders is immaterial if a reorganization of the corporate business is in fact accomplished. A reorganization occurred when the series of undisputed transactions was considered as an integrated whole. Apparently a transfer of assets to a continuing corporation is not disqualified as a reorganization merely because the motive for the transaction was solely to benefit the stockholders.

Several months before this case was decided, the First Circuit rendered an opinion in a somewhat similar reorganization[12].

All the stock of a corporation was held by trustees of an estate. In 1941, the corporation which was engaged in three different lines of business sold two branches of the business for cash and securities. On December 29, the corporation transferred the assets pertaining to the third branch of the business and $90,000 in cash to a new corporation organized by it, receiving in exchange all the stock of the new company. A half hour later the old company voted to liquidate and distributed the remaining assets consisting of cash, stocks and bonds, and the stock of the new company, cancelling the stock of the old corporation.

On liquidation there was a gain of about $66,000 which the stockholders reported as a capital gain under 115(c). The Commissioner held that the liquidation constituted an exchange pursuant to a plan of reorganization under 112(b)(3), that the distribution had the effect of a distribution of a taxable dividend and so taxed it as ordinary income under 112(c)(1) and (2).

The Tax Court upheld the Commissioner and taxed the distribution as an ordinary dividend on the authority of the *Bedford* Case. The petitioners contend that since a business purpose was lacking no reorganization occurred.

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(10) 315 U. S. 179 (1942).

(11) 293 U. S. 465 (1935).

(12) *Harriet S. Lewis* v. *Commissioner,* 160 F(2nd) 839 (1947).

The Circuit Court was of the opinion that in substance the ultimate result of the series of transactions was to effect a partial liquidation. Such a gain in 1941 would of course have been a short term capital gain and fully taxable.

On the question of business purpose the Circuit Court remanded the case for a specific finding on that issue. It did however say that none of the usual examples of business purpose seem to be present here, such as modification of the corporate structure, the addition of new business enterprises, or the severance of part of the old. It also adds that if the Tax Court found that a business purpose existed or was lacking the rule of the *Dobson* case would prevent a review of the question. It also said that if the Tax Court were to say that a reorganization under 112(g)(1) had occurred despite the lack of a business purpose, a clear cut question of law would then be presented to the Circuit Court.

It should be noted that this is not the usual case where a taxpayer is arguing that a reorganization exists in order to take advantage of the tax free exchange provisions. Here it is the Commissioner who spells out a reorganization in order to give a distribution the effect of a dividend taxable as ordinary income.

Time limitations prevent an adequate discussion of the doctrine of business purpose particularly in the light of some of these cases which seem to ignore the doctrine entirely, or at any rate, to minimize it.

Undoubtedly this issue will be before the Courts again. In the meantime, the taxpayer is again left in much doubt as to whether he is or is not accomplishing a tax-free reorganization.

Incidence of Federal Taxation upon Separate Entities

By Maurice P. Geller, C.P.A.

It is apparent that many reasons exists for the need to conduct business activities in the form of separate corporate entities. These separate units are frequently dominated by controlling stockholders acting as officers or directors. The maintenance of such separate entities in the conduct of business affairs may result in tax savings, the taxpayer's ultimate dream. The Courts have frequently reviewed these situations and have developed the doctrine that tax benefits may be obtained by whatever legal right the taxpayer might employ (*U. S.* v. *Isham,* 17 Wall. 496), including doing business by means of separate entities. To what extent these benefits will be recognized by the taxing authorities is always a perplexing problem. Generally, the proposition of doing business in corporate form as an activity separate and apart from its controlling stockholders has been recognized as valid. Congress has also recognized the general principles involved. However, it has enacted special tax legislation to permit, restrict, penalize, or defer or postpone taxes as between stockholder and controlled corporation, without implication of tax evasion.

The exceptions to the general rule have been developed in many interesting cases which will be analyzed. From these cases, conclusions may be reached concerning the probability of recognition of the separate corporate identity.

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In some cases, the Court has characterized the result as a sham lacking in business reason, or has questioned the purpose and bona fides, criticized the desire to reduce taxes, or carefully examined and investigated the form and substance of the transaction and relationship between the corporation and the controlling stockholder with special reference to its effect on tax incidence.

Some Applicable Statutory Provisions

This legislation has had a direct influence upon the incidence of taxation. Statutory recognition of separate entities may be found in the following sections: Transactions (losses) between a corporation and stockholders (family transactions) are disallowed by I. R. C., Section 24(b). Section 45 authorizes the Commissioner to reflect clearly the income of any organizations owned directly or indirectly by the same interests, by reallocation of income, expenses and credits. I. R. C., Section 102, which imposes a surtax on the unreasonable accumulation of surplus (except for proper reasons) if dividends are not declared annually to the stockholders. Due to the statutory exemption afforded in I. R. C., Section 112(b) and 112(g), transfers or exchanges between stockholders and corporations may not be taxed until a later date. I. R. C., Section 141, permits parent and affiliated corporations to seek tax advantages by offsetting losses of some as against gains of others, within affiliated groups, by filing consolidated returns. I. R. C., Section 129, was enacted to prevent acquisition after October 8, 1940, of deductions, credits or allowances against income or excess profits tax by acquiring control of a corporation which is entitled to such deductions or allowances. The Senate Finance Committee stated that if a controlled or affiliated group existed on

October 8, 1940, transfers thereafter within the group could not amount to the acquisition of such control by a parent or its controlling group. In I. R. C., Section 500, personal holding corporations will be penalized on undistributed subchapter A net income. Special surtax exemptions are allowed to corporations trading in the Western Hemisphere and qualifying under I. R. C., Section 109. The Bureau has ruled (IT 3757, 1945, CB 200) that the creation of a new domestic corporation to carry on in the Western Hemisphere the business of an existing domestic corporation does not constitute tax avoidance within the meaning of Code Section 129, although created for the sole purpose of tax exemptions under Code Section 15(b). Stockholders of Personal Service Corporations are required to include Supplement S net income in their annual income (I. R. C., Section 725; 391).

General Rule: Judicial Construction

The Courts have recognized the principle that the corporation will be generally regarded as separate legal entity, entirely distinct from those who own or control it.

The Federal Courts have resolved this question in *Peterson* v. *Chicago Rock Island R. R.*, 205 U. S. 364, and in *Hall's Safe Co.* v. *Herring-Hall-Marvin Safe Co.*, 146 F. 37. The New York State Court resolved this question in *People* v. *American Bell Telephone Co.*, 117 N. Y. 241; *Berch* v. *U. S.*, 54 F. Supp. 175.

In discussing the wisdom of recognizing separate entities, Justice Holmes said,

> "It would have been preferable to respect the corporate entity separateness. It leads nowhere to call a corporation a fiction. If it is a fiction, it is a fiction created by law with intent that it should be acted on as if true." *Klein* v. *Board of Tax Supervisors*, 282 U. S. 19.

The Supreme Court recognized separate entities in *Lynch* v. *Hornsby*, 247 U. S. 339. It also discussed the question in *Eisner* v. *McComber*, 352 U. S. 189, in which it said,

> "We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact, but because it is only recognizing such separateness that any dividend, even one paid in money or property can be regarded as income to the stockholder."

The general rule of recognizing the distinction between stockholders and corporation was applied again in the transfers between the corporation and its stockholders in *Burnet* v. *Commonwealth Improvements Company*, 287 U. S. 415, reversing 57 F.(2) 47, which in turn reversed the Board of Tax Appeals, 20 BTA 1189. The taxpayer was old and the double purpose for forming a corporation was to avoid multifold death duties or transfer taxes on successive transfers by inheritance and to insure the safety of an endowment which the sole stockholder wished to sponsor. The sole stockholder transferred large blocks of investment securities to the newly formed corporation in exchange for its stock and debentures. The corporation exercised rights to subscribe to additional shares of such stock and reduced its cost to $18.806875 per share or $4,231,566.88 for the 225,000 shares involved in the instant transaction. The stock had a market value of $5,287,500. These shares were sold at their market value to the sole stockholder's assignee, an estate, in cancellation of certain debentures owed to it by the corporation and other securities owned by the estate. A profit was realized of over one million dollars in this sale, and was taxed by the Commissioner. The taxpayer claimed that there was no profit or loss on the transfer to or from the corporation and that the corporation and the sole stockholder were the same entity. The Board of Tax Appeals was reversed by the Circuit Court, which was, in turn, reversed by the Supreme Court. It said that the sole stockholder sought to ignore the benefits that he and the corporation had enjoyed from separate existence by requesting that the corporation and the single stockholder be overlooked only with respect to transactions which take place between them. The Supreme

Court affirmed what the Board of Tax Appeals determined, stating as follows:

> "The fact is that the petitioner did have a separate legal existence with privileges and obligations entirely separate from those of its stockholders. The fact that it had only one stockholder seems of no legal significance. *Cannon Mfg. Co.* v. *Cudahy Co.*, 267 U. S. 333."

In *Burnet* v. *Clark,* 287 U. S. 410, the loss was disallowed under Revenue Act of 1921, Section 204(a). The principal stockholder endorsed notes for the corporation of which he was the guiding executive and suffered a loss. The Commissioner disallowed the loss inasmuch as it was not a proper corporate deduction, nor a business loss allowable on his personal tax return. He did not regularly conduct a business of endorsing a note for profit. The Supreme Court treated them as separate entities and did not regard the corporation as his *alter ego* or agent. The taxpayer had also treated the corporation as a separate entity for taxation. The Court concluded by saying,

> "A corporation and its stockholders are generally to be treated as separate entities. Only under exceptional circumstances not present here, can the difference be disregarded. See also *Klein* v. *Board of Supervisors, supra; Dalton* v. *Bowers,* 287 U. S. 404."

In *New Colonial Ice Co., Inc.,* 292 U. S. 435, the Supreme Court disallowed a net loss of a predecessor corporation from its income tax return. The Court held that in law and in fact the two corporations were not identical but distinct, implied by the transfer of assets and business from one to another and that thereafter neither corporation had control over the other. (*Peabody* v. *Eisner,* 247 U. S. 347) The Court said, the general rule is subject to qualification that the separate entity may be disregarded in exceptional situations which otherwise would present an obstacle to the due protection or enforcement of public or private rights. (See *Southern Pacific* v. Lowe, 247 U. S. 330.)

The Supreme Court, in another case, stated its opinion that for tax purposes the corporation and stockholders are not to be merged and that the tax advantages or disadvantages follow the choice of a form of business activity adopted. In *Moline Properties, Inc.* v. *Commissioner,* 319 U. S. 436, the income was determined to be that of the corporation not of the sole stockholder. The corporation had originally been formed under pressure from a creditor to assume certain liabilities of the transferor, and for other business reasons such as receiving additional working funds from this creditor. The stock of the corporation was held by a voting trustee nominated by the creditor to secure the new funds needed by the corporation to pay back taxes on the real property transferred. The corporation repaid the creditor and the property was sold thereafter. The corporation also entered into other and separate purchases from the original one. No agency existed here between corporation and stockholder. The Supreme Court found that the corporation was not a figmentary agent and declined to disregard the corporate entity.

In a recent case, a parent corporation operating interstate buses guaranteed the loss incurred by a subsidiary operating in California. It deducted the deficit of the subsidiary from its operating profits. The guaranteed payment of the subsidiaries' deficit was disallowed as a parent company expense inasmuch as the separate entities could not be disregarded. *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590, aff'g. 130 F(2) 136, and aff'g 44 BTA 957. See also *Los Angeles & Salt Lake* R. R. Co., 4 TC 634; NA 1945, CB 8.

This doctrine of separability was followed in the case of *Commissioner* v. *P. O. B. Montgomery,* 144 F(2) 313, aff'g. 1 TC 1000; NA 1943, CB 36. The corporation was owned principally by stockholders other than Montgomery (wife, children and brother). On July 1st, it received an assignment of a contract to complete a construction job which Montgomery had commenced and which was one-half finished when transferred. Montgomery was not em-

ployed by the corporation to supervise the job nor did the assigned contract provide for his personal services. The corporation was to complete and deliver a finished building. Montgomery paid a tax on the profits realized on the portion of the work done by him before assigning the contract to the corporation which finished the work three months later. It reported its profit which the Commissioner sought to tax to Montgomery individually. The Circuit Court said in taxing the remainder of the profits to the corporation that,

> "We think the prosecution of the work after July 1st, though it had apparently been well organized before, was a business one within the corporation's charter powers, and attended with business risks, and that its profits belong to the corporation. That the corporation was organized through a gift of money by Montgomery to his children, and that he has to some extent since served it without charge, does not alter the matter. The judgment of the Tax Court is according to law, and is in both cases affirmed."

Separate Entity Disregarded

In a case tried before the Second Circuit Court of Appeals, the doctrine of separate entities was disregarded in order to carry out a legislative purpose. It was held that the petitioner, a parent corporation, owning all the stock in eight subsidiary corporations, should be treated as the owner of the subsidiaries' vessels. It was, therefore, entitled to deduct in computing its net income subject to profits taxes under the Revenue Act of 1918, the amount of its net earnings invested in the construction of new vessels as provided in Section 23, 46 USCA, Section 878. See *Munson S. S. Line v. Commissioner*, 77 F.(2) 849.

The separate corporate form was ignored in *Asiatic Petroleum Company*, 79 F.(2) 234, cert. denied 296 U. S. 645, where certain domestic stock was sold to a foreign corporation. The transferee and the transferor had the same stockholders so that it was immaterial to the beneficial owners of the potential income whether it was realized by one business or the other. The foreign corporation in turn sold it to another domestic corporation at a substantial profit. The Court taxed the income realized by the foreign corporation to the taxpayer (transferor). This transfer was made for the purpose of having the profit escape taxation; the Court would not agree to this and upheld the Commissioner in applying Section 45 of the 1928 Act and his allocation of profit from the sale to the petitioner.

In Bourjois, Inc., 300 U. S. 682, 85 F.(2), 510, the Supreme Court disregarded separate corporate entities, and denied certiorari. In this case, the company sought to reduce its excise tax liability by the means of selling to wholly-owned subsidiaries at a small profit. These subsidiaries resold to the trade at higher prices made possible by the well known and valuable trade names owned and controlled exclusively by the parent corporation. The decision to tax the parent company and ignore the separate entities of the subsidiary corporations rested firmly on the grounds that (1) the sales price determined in the ordinary course of business was that price at which the parent had sold the merchandise prior to the organization of the subsidiaries, (2) with respect to the first outside sale, that the product was sold under the well known trade names and was not in the same class as unbranded merchandise.

In the case of *United States* v. *Morris & Essex R. Co.*, 135 F.(2) 711, cert. denied, 320 U. S. 754, the stockholders received directly the rental income from property owned by the corporation.

The government sought and was sustained in its effort to tax the lessor corporation on the income from lease of its property. The existence of the lessor corporation (during its charter) was essential to the execution of the lease. The lessee also agreed to pay all income tax debts which was never done. The Court said of the corporate entity separate from its shareholders,

> "The lessee might default, and they (stockholders) would then wish to retake their railroad, for whose operation a corporation would be essential. For these reasons, they continued to use corporate form, and they cannot retain the privilege without accepting the burden, one of which is that any collective income shall bear a tax. The Courts will not allow the fictitious personality of a corporation to be used as a means of avoiding public duties; and the form of this transaction cannot conceal the truth that payments to the corporation are for all practical purpose payments to the shareholders and payments to its shareholders, payments to the corporation."

The same Circuit Court in a later case (*National Investors Corporation, Appellee* v. *Jane M. Hoey, executrix-appellant*, 144 F.(2) 466) said of the above quotation that the treasury may disregard corporate form only if it is unreal or a sham.

In *United States of America, appellant* v. *The Brager Building and Land Corporation, appellee*, 124 F.(2) 349, 4 Circuit, the income was taxed to the partnership and not the corporation, which held passive legal title to property as a convenient agency for the partnership. The corporation had no business activity; it did not assume the mortgage debt; it had no capital, bank account, office, or books of accounts.

In *Thomas K. Glenn*, 3TC 328, the corporation was regarded as the *alter ego* of the sole stockholder; the corporation having been formed for the sole purpose of holding various assets of his. The corporation did no business, merely served a personal convenience. The loss on liquidation of this corporation was denied for the reasons above.

Reduction of Taxes—Tax Avoidance

The devices used by the taxpayer to decrease its tax liability have taken many varied forms. The ideas have been ingenious and it is to the credit of the Commissioner that these have been carefully examined for the effect on proper tax incidence. The judicial recognition of tax avoidance schemes and evasion has been considerable, and, much time and thought has been devoted to determining a fair standard of evaluating the conflicts which arise from time to time. No attempt will be made to discuss fully the subject of tax avoidance, or to collate the many court decisions, but some sampling will follow.

The Commissioner has applied I. R. C., Section 45 to protect the Revenue. The long legislative history of Section 45 was discussed in *Asiatic Petroleum, supra.* It reiterated the intent of Congress to prevent the shifting of profits, the making of fictitious sales and other methods adopted for the purpose of "milking". In these cases, the Commissioner is limited to allocation between two or more organizations owned or controlled directly or indirectly by the same interests to (1) prevent evasion of taxes and (2) to clearly reflect the income of any such organization, trade or business. (See 69th Congressional Record Part 2, page 1068). In the above case, the Court held that the Congressional definition included the attempt to "milk" profits of a domestic corporation by a foreign parent or parents. This was regarded as a means of placing profits beyond the reach of taxing authorities. The separate entities in this case were therefore disregarded.

Section 45 was again the means in attempting to reallocate income between a corporation and a partnership (*Epsen Lithographers, Inc.* v. *George W. O'Malley*, Collector of Internal Revenue, D. C. Nebraska 6/14/46, 67 F. Supp. 181) which attempt was denied by the Court. The partnership was formed to take over the corporation's business. The capital of the partnership was contributed out of separate funds of the partners and that the rental paid to the corporation for leasing its assets was a fair one. The purpose of creating a partnership was to give certain members of the family a greater share in the business and to secure for the business the benefit of their skill which would otherwise have been lost, and not tax avoidance. In discussing the subject of tax avoidance, the District Court

reviewed many of the Supreme Court decisions with respect to fundamental and well recognized principles in the field of tax law, and reiterated for guidance.

> "Legislative words, particularly in the provisions of a tax law, are not inert and derive vitality from the obvious purpose at which they are aimed. *Griffith* v. *Commissioner,* 308 U. S. 355; 40-1-USTC 9123; quoted with approval in *Nebraska National Hotel Co.* v. *O'Malley,* 63 F. Supp. 26 (D. C. Neb.)" See Mertens Law of Federal Income Taxation, Volume 8, Section 46:69.

In *Sanford Corp.,* 106 F. (2) 882; cert. denied, 309 U. S. 659, the corporation (Personal Holding Corporation) sought and was denied a dividend paid credit inasmuch as the dividend was not actually paid within the year in question. (Section 351 (b) (2) (c) Revenue Act of 1934.) The sole stockholder had no knowledge of the declaration of the dividend during his absence and could not return in time to pay it during the year, but actually did in the next year. The Court said this type of tax avoidance ("incorporated pocket book") was discussed at length in the hearings on the Revenue Act of 1937, before the Joint Committee on Tax Evasion and Avoidance, Part 1, p. 186, in which it was determined that as early as 1913, the corporate fiction might be put to another use having the aroma of impropriety. The basic purpose of Congress was to empty the "incorporated pocket book", a different purpose from the prevention of accumulated corporate surpluses in unworthy cases.

The following are a few of the other cases dealing in the principle of separate entities which used the separability as a tax saving device. It was held that the creation of trusts for tax saving purposes is not fatal. See *Elizabeth K. Lamant,* 43 BTA 61. In another case, it was decided that it was proper for trustees to perform their duties in such a way as to save taxes. See *John D. McKee et al., trustees,* 35 BTA 239; A, 1937-1-CB 10. The doctrine applies to partnerships *Chisholm* v. *Commissioner,* 79 F. (2) 14; cert. denied, 296 U. S. 641.

In all instances of separate juristic persons, the treasury follows the substance of the transaction to determine whether the method adopted to carry the plan into effect was unreal or a sham. This was true in *Higgins* v. *Smith,* 308 U. S. 473, involving the deductibility of a loss on a sale of securities (under the 1932 Act) by Smith to a wholly-owned corporation whose transactions were restricted largely to dealings with its stockholder. The deductibility of the loss was denied. It was not a real loss because of the sole ownership of the corporate stock by the stockholder. Under the present Code, Section 24(b), this is not permitted as a matter of law.

In *Campana Corp.* v. *Harrison,* 114 F. (2) 400, the case involved excise taxes and turned upon the fact that sales to a corporation having the same stockholders were not arms length transactions. *Continental Oil Co.* v. *Jones,* 113 F. (2) 557, cert. denied, 311 U. S. 687, also dealt with excise tax on sales to wholly-owned subsidiaries. These corporations were utilized as mere instrumentalities for the purpose of avoiding an imminent tax. The government will strike down frauds on the tax statute.

Bona Fides — Good Business Reason

Transactions between stockholders and controlled corporations have taken many forms in an effort to reduce tax liability. The Courts will in each case apply certain basic tests in examining the facts before finally determining the efficacy of the tax savings efforts. One of the most important of these tests is the reality of the separate entities. The Commissioner will decline to permit legal devices to save taxes if the transaction is temporary in nature, a sham or fiction, not bona fide, and completely lacking in a sound business purpose or activity.

In the well known, and perhaps one of the most quoted cases in tax history,

Gregory v. *Helvering, supra,* the transaction, which otherwise would conform to the tax free reorganization features permitted in the Internal Revenue laws, was disallowed because the transaction was temporary and without a sound business and corporate purpose. The Court said that it wished to fix the character of the transaction, eliminating the tax saving motive, and it found that the sole object was not to reorganize a business but to transfer a parcel of corporate stock to the individual through the means of a new corporation organized for this purpose, and was then dissolved. The Court pierced the veil of legality, or form of the transaction, and decided that there was no reality or substance to the matter and accordingly disallowed the tax free reorganization and made it a taxable transaction.

To some extent, this decision appears to be conflicting with *Chisholm* v. *Commissioner, supra,* in that (1) a motive to reduce or otherwise avoid taxation does not invalidate a transaction otherwise legal in form, and that (2) regardless of the form, where the object of the transaction is tax avoidance the tax consequences will flow from the substance rather than the form. In the *Chisholm* case, the purpose was to form an enduring firm (partnership) which should continue to hold the joint principal, to invest and reinvest it. The brothers chose to deal in the property by transferring and pooling it in a single firm. The basis of certain assets were increased. The litigation concerned itself with a basis problem which has since been eliminated by the Revenue Act of 1934, stating rules for the first time for determining the basis of the assets transferred to a partnership (Now, I. R. C. Section 113 (a) (13)).

Avoiding taxation cannot be the basis of liability, but where the purpose contradicts or defeats the apparent transaction it is that purpose, rather than the purpose to escape taxation, which permits the Court to disregard the form. See *Louisville Trust Co.* v. *Glenn,* 65 Supp. 193. Here following a liquidating dividend in kind, a sale was completed by the stockholders, not the corporation. This was affirmed by the Court.

Many stratagems are used to reduce or transfer tax incidence. Frequently, stockholders of a corporation organize a new partnership, ownership resting in the same proportions, to carry on a phase of the corporate activities. This is accomplished by mutual agreement as to the business functions and activity to be undertaken by the partnership, formerly a function of the corporation, and as to the other rights of the respective parties. The Commissioner has consistently followed these attempts. When he is successful in establishing a lack of sound business purpose, he will reallocate the income of the partnership to the corporation. The authority for this is vested in I. R. C., Section 45.

The Tax Court in a recent case, *Seminole Flavor Company,* 4 TC 1215; (A), 1945 CB 6; did not consent to the reallocation of income between a corporation and a partnership owned by the same interests by the Commissioner. The Tax Court thought there were good and sufficient reasons for the separate entities based on the facts. It was proved during the trial that the partnership assumed certain obligations under the contract between the parties. The corporation was to devote its entire effort to the manufacture of its product, and the partnership was to sell it to the customers. The partnership was to promote the product and trade name of the corporation, thereby stimulating the sales of the customers. New methods of dealing with customers were introduced by the partnership and a large advertising campaign was started. It was the Court's problem to evaluate the contract between the parties on a basis of an arm's length transaction. The Court said it believed the compensation between the two parties as fair and reasonable. During the trial, the Commissioner urged that the partnership be ignored although he had already recognized the existence of the same partnership, its conduct, and of its

business and deductions. The partnership was a separate business enterprise which in itself was a sufficient business reason. It was this determination which enabled the Court to reach its decision that the corporation had sustained the burden of proof with respect to validity of the separate entities. They were permitted to stand as filed.

This recognition of the separate existence of a partnership and corporation as separate entities was settled again in *Nichols & Co.* v. *Secretary of Agriculture,* CCA 1st Circuit, 131 F. (2) 651 (not a tax case). Here it was held that a corporation composed of members who were stockholders in a corporation of the same name, and whose interests in the partnership were identical with their stock interest in the corporation, could not be disregarded by the Secretary of Agriculture in administering the Commodity Exchange Act. There was a sufficient business reason for their recognition by the Courts.

This was evident in *W. R. Ross, Petitioner* v. *Commissioner of Internal Revenue,* 129 F. (2) 310; rev'g. 45 BTA 1155. The corporation of which W. R. Ross was practically sole stockholder conducted an auction business and all its related feeding and financing activities. W. R. Ross and association conducted simultaneously a partnership of buying and selling livestock. There were years in which one lost money and the other made money, but the controlling stockholder chose to keep the entities separate. Combining these entities might have resulted in some tax saving in some years which he chose not to take advantage of. It was clear that the corporation was used for the auction business representing sellers in feeding, financing and auctioning off their cattle and W. R. Ross remained in the other business of buying and selling mules. Frequently, he bought from his own auction company. These two activities were not in conflict. W. R. Ross was treated by the corporation exactly like any other account. It was true that W. R. Ross and his associates worked at the same time for the company and themselves, but this was not sufficient reason to consider the corporation as another pocket and provide the reason for disregard of separate entities.

Reasons were found to be present where a bank organized a subsidiary to engage in the real estate and mortgage business. It originally loaned money on mortgages and was compelled to foreclose and operate these properties, awaiting the day when it could liquidate the transaction and retire from the real estate business. The real estate corporation, all of whose stock was owned by the bank, was organized in 1932 and continued to operate until 1944, when it was finally liquidated. In December, 1944, the bank decided to liquidate the real estate company. In order that Section 112 (b) (6) not be applied, the bank sold one-quarter of its stock in this real estate company and liquidated it. The issue before the Court was a loss taken in 1941 by the bank on retirement by the real estate company of a portion of its capital stock, inasmuch as it was not in need of all of the funds on hand. The Commissioner's theory was that the real estate corporation was so dominated by the bank that it should not be recognized as a separate corporation. This was rejected by the Court since it recognized legitimate business reasons for the organization and operation of the real estate company inasmuch as it was impractical for a banking institution to engage in the real estate business. The Court found that the retirement in 1941 was not part of a plan to liquidate in 1944. It was not known in 1941 definitely whether and when the company would be liquidated. The loss on the retirement of stock in 1941 was permitted to stand. *Rhode Island Hospital Trust Co.,* 7 TC 211; (A) 1946 2 CB 4.

A very interesting case, *Comm. of Int. Rev.* v. *Greenspun,* 156 F. (2) 917, (C.C.A.-5, July 19, 1946) concerned itself with a sole stockholder who caused his wholly-owned corporation to

resell to him, at cost, certain assets purchased from him the year before. Thereafter, the corporation rented these cylinders, and other cylinders as well which it had never previously owned. Many years later, the sole stockholder transferred to irrevocable trusts all these assets whether or not previously owned by the corporation, and the right to these rentals. The beneficiaries of the trust were his children. The Commissioner attacked these separate entities and (1) sought to tax the trust income to the grantor, (2) sought to disallow the rentals as expense to the corporation, and (3) sought to tax the rentals paid by the corporation as informal dividends to the grantor. The Circuit Court reversed the Tax Court and (1) allowed the trusts as valid and (2) it allowed payments of rentals in fair amounts as deductions by the corporation, and (3) the balance of rentals were chargeable to the grantor as informal dividends. The Court believed that this was not tax dodging device but that the transaction had reality.

The lack of a good business reason or the determination of the presence "sham or fiction" in a business activity has been the prime force in the Commissioner's litigation before the various judicial bodies. This covered a great variety of cases. In a recent case, accrued interest on bonds was sought as a deduction by a corporation taxpayer. Its bonds were owned by another corporation which also owned all of its capital stock. The circumstances were such that disregarding the parent subsidiary relationship, no reasonable person could assume that payment would ever be likely to occur. The Court said that if ever there was a case where flimsy paper transactions were put forward as a basis for tax avoidance this is it. See *Prudence Securities Corp.* v. *Commissioner,* CCA 2, 135 F. (2) 340.

The cases are voluminous with respect to good business reasons as a basis for recognition of separate entities. Other good business reasons include gaining an advantage under law of the state of incorporation; *Texas Empire Pipe Line Co.* v. *Commissioner,* 127 F. (2) 220; or to avoid the demands of creditors, *Sheldon Building Corp.* v. *Commissioner,* 118 F. (2) 835, or to comply with demands of creditors, *Palcar Real Estate Co.* v. *Commissioner,* 131 F. (2) 210.

In *Samuel S. Paymer* v. *Commissioner,* 2 Circuit, 150 F. (2) 334, two corporations were organized by a partnership to hold title to the property and deter creditors of one of the partners. The profits and control of the assets were to rest in the individual stockholders. In the case of one corporation, it borrowed money and gave as security leases as the sole lessor. This was considered a business activity and accordingly, the income treated as the corporation's not the stockholders'. In the case of the other corporation, no such business activity existed here. Here, the stockholders received some rental income of the second corporation and it was treated as income to them. Separate entities were recognized in one instance and ignored in the other.

Conclusion

The preceding discussion should enable a practitioner reasonably to appraise a given set of facts to determine whether or not the general principles of separate juristic persons actually exist.

The principles by which separate entities are recognized and approved have been well settled by the Courts. As analyzed above, they will be recognized if certain conditions exist such as a corporation not being a mere agency or a department of another. The presence of a sound business reason, or its equivalent will be sufficient to keep them apart. It will be recognized where a new corporation was organized to carry out a legislative purpose. The separability will be rejected when based on a temporary expedient, or when the net income of one is not clearly reflected resulting from improper allocation. The separability will not be recognized if the corporations exist in an atmosphere of sham or evasion.

A Better Deal for the Employee

By J. K. LASSER, C.P.A.

ONE of the most essential fields for tax planning is in compensation. Our system of free enterprise depends for its entire existence upon men—their perspiration, their ingenuity, and their leadership. Free enterprise will work only if we can give free men the desire and the incentive to expend their talents. Instead, our tax laws are a real brake on our most important individuals. That is because our system takes so much after salaries reach up over $10,000 or $15,000. After $20,000, your added payments go at least 50% to the government. At $50,000, the tax collector takes almost 70% of additional sums. And at $90,000, you are giving up 75% of the next dollars you earn. What, please, are the chances to encourage men to more perspiration, ingenuity and leadership? Common sense says these rates should never exceed 50%.

If taxes continue at their present high levels, they may, in effect, cause a managerial revolution. They are today —in endless examples—removing the incentive to work for a considerable number of those who comprise our most enterprising, skillful and talented management group.

Business and its tax planners have an enormous obligation to help curb this managerial revolution. That means a constant search for approved plans to

1. *Defer* compensation to *later* years when the tax might not be so high.
2. Possibly *eliminate* the tax altogether by avoiding direct payment.
3. *Defer* the tax to a period when the employee might possibly get a capital gain for his services, or *avoid* tax if he does not cash in.

We avoid the taxing of compensation entirely by a great many plans that are part of a good management program. The record here is some of the more recent thinking on the subject:

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He has written extensively and is the author of *Your Income Tax, Your Corporation Tax,* the *Business Tax Guide,* the *Business Executive's Guide* and a host of articles, principally on tax matters. He is also the editor of the *Handbook of Accounting Methods.*

He also conducts *The Tax Clinic,* a regular monthly column dealing with current tax matters in *The Journal of Accountancy.*

Deferring Income to Later Years

Sometimes the employer may find it advisable to defer his deduction to later years and, at the same time, to permit the employee to be taxed later. The employee may have much more to gain in view of the great disparity in tax rates for individuals and corporations.

First to be used in that group of ideas would be plans for salary adjustment. If a man is ordinarily paid $10,000 a year, there is no bar to paying him $8,000 this year and $12,000 next year, subject to the requirement that both payments shall be reasonable for his services.

If an employee elects voluntarily to take a reduction in salary for this year, he has no income on the amount eliminated. He may do that hoping you will increase his income next year. If

his salary for 1947 is $10,000 and he elects to accept $8,000 instead of the entire sum due, and actually makes the adjustment the $2,000 is not taxed.

Employees also probably would have no tax to pay on this reduction if they suggested that the salary waived be given to a charity. On the other hand, if the employees insisted that the amount waived be given to a designated person, then it would be income to them.

If an employee's compensation is impounded, postponed, forfeitable, or subject to defeat by the nature of the employment arrangements—there is no tax due until payment is made to the employee. Or if payment is prevented by lack of funds, there is tax due only when payment is actually made. To be taxed, compensation must be *unrestricted, determinable,* and *available.*

Use of a Trust System to Defer Income to Later Years

If an employee enters into an agreement under which any part of the money due to him is placed in trust subject to some act, or some omission of an act, or the passing of time, he pays no tax until the time for the happening of the contingency is passed. This rule is often used to get a deferral of income for the employee. Many arrangements of this type are used.

In these, the employee has income when specified events occur in the future years. For example, you may postpone income for an employee (if salary ordinarily due this year is paid in a later year) upon the employee's agreement to do one of the following:

1. To be available for work as a consultant for a definite number of days in each of the future years.
2. Not to work in any similar line of business for the future years to which payment is deferred.
3. To accept compensation in the future based on results in later years. For example, a sales manager could get his future salary based on sales in the future year.

Many of these contingent agreements postponing compensation to later years —which might ordinarily be paid now —start with recognition of the employee's "net after taxes." If a man earns $50,000 a year and you pay him another $10,000—he will normally have only $2,875 left out of that. At the same time, your real disbursement (with 38% corporate rate) is only $6,200. Out of these figures we get this type of computation—

The corporation can afford to pay $6,200 without desire for a tax deduction. The individual really is getting only $2,875 annually. If he is 40 years old and retires at 65, the total net amount for the 25 years (under present rates) would be only $71,875.

The corporation might buy an annuity policy for itself with the $6,200 in order to pay the employee in later years. The individual would not be taxed on any part of these annual premium payments if his rights to future salary were contingent on services or ommission of services. If a corporation buys a 20-year annuity or endowment policy payable to itself, proceeds are taxfree to it when collected, up to the amount of its investment. These proceeds could then be paid out as an annuity to the individual, on retirement, securing a deduction for the annual payments then made.

Assume that the individual is 40 years old, and the employer buys an endowment-at-age-65 policy, paying $6,200 annually. With the dividends left to buy paid-up endowment insurance, the endowment at maturity might approximate $161,000. By electing to receive the proceeds in installments for 10 years, it might yield $17,500 annually for 10 years. It could pay him $30,500 annually for 10 years after his retirement. This $30,500 would be deductible, saving $11,590 in taxes. Its net cost would be only $18,910.

The individual would pay a tax of $12,265 (under present rates) on this $30,500. That leaves him a net income of $18,235, or $182,350 for the 10 years after retirement. By giving up a net income of $71,875 over a 25-year period, the individual might be receiving a total of $182,350.

The great advantages of these plans are—

The employee is assured of a retirement plan and security in his later years. The company need not try to adopt the usual pension or profit-sharing device. The company can prevent him from working for a competitor. The company can consult with him and get the benefit of his experience.

The company makes certain to keep the employee close to it during his retirement.

Even with the employee's death before retirement, the plan might easily take care of the employee's family for the agreed period—insurance is best for this. Make the proceeds of the company's policy payable to it. Then the proceeds would not be taxed upon receipt. It could, however, deduct the payments made to his family. If the employee dies after retirement but before he has received the fixed number of payments, his family can still get the remaining payments.

Provisions can be made for payments during a period of illness. The corporation gets a deduction for the retirement payments—when made out of the collection of its endowment policy. The penalty for accumulating earnings may not be imposed on the funds used to set up the plan. You can readily show that a sound business need is being served by this plan. These needs include: Influencing valuable employees to remain permanently in the company's service; preventing them from competing with the company after retirement; preventing them from giving confidential knowledge to competitors; retaining the right to consult with them and getting the benefit of their vast experience.

(The Treasury may dispute this, especially, if you have a close corporation and only stockholders are included in the plan. It may contend that the purpose of the payments under the plan was to prevent the surtax against the stockholders.)

Some authorities argue that the agreement with the employee should provide for annual payments to buy the endowment of less than 62% of the salary originally due. This is urged on the theory that the corporate tax may be less than 38% over the period before retirement.

Some agreements provide that the employer will accumulate a part of the compensation which is already earned and which might ordinarily be paid at once. The sums thus accumulated are then distributed to the employee this way—

Annually at retirement to the employee or his wife, if she survives him. For example, if there is an accumulation of $50,000, you might spread it over 10 years, paying $5,000 a year.

Periodically in the event of the employee's death or total disability before completing the employment period. In this way, the employee or his heirs would get almost all of what he had accumulated in his account, spread over a long period.

Some sum smaller than the accumulation, if the employee voluntarily terminates his employment with the company. This might be dismissal compensation under the plan.

Under this plan the individual has no tax until he gets paid, since some of his rights are forfeitable. That arises because he is paid his deferred compensation only if he continues in his employment to the end of the contract. Also, the contingency may be imposed that the employee is entitled to receive the deferred compensation only as long as he does not later work for a competitor. In these cases he has no income until he receives the payments. Until that time he has merely received the employer's conditional promise to pay in the future upon the happening of certain contingencies. This is not property which can be taxed.

If the entire balance due were nonforfeitable—or if the employee's accumulations can surely be collected, then we have a tax to the employee of the balances due as they are being built up each year. Of course, when forfeitable accumulations are made, the company gets no deduction for any portion of the deferred compensation until the actual payments of these sums are made to the employee.

If forfeitable accumulations are paid to the widow of a deceased employee, they are fully taxed to her. They are often deliberately spread over a longer period of time and at reduced amounts. This has the effect of—

Reducing the tax liability of the widow. Providing a longer number of years of secured income for her. Recognizing that the annual needs of the widow would be less than the needs of both the wife and husband while living.

Sale of Stock to Employee Can Avoid Much Tax to Them

There is nothing to prevent employers from making a bona fide loan to an employee to purchase stock, even if he has to pay off the loan through a sale of the stock. If that avoids a tax on his increase in stock value, it still

is proper. But in all such methods, you get no tax deduction for the increase in value of the stock. You do get this deduction—

If you pay him for services in stock—your deduction is the fair market value of the stock.

If he buys stock at a bargain price and you intend the bargain to be of services—your deduction is the difference between fair market value and the price he pays.

Some employers lend key employees money to buy their stock and accept the shares as security for the loan. If the employee fails to pay the loan, the shares may be forfeited and used to pay the debt. In these cases, the employer still gets his deduction as compensation for any excess of the value of the stock over the sale price.

Some arrangements provide for the outright sale of stock to an employee supported by: down payments; interest-bearing notes in payment of the balance due; agreements for deductions from salary; credit of his dividends; and direct payments. In these, the difference between the value of the stock and the sale price may not be taxed as compensation, even though the employee acquired the stock at a bargain. But it may still be taxed as compensation if you so intended it.

Not all employer arrangements to give stock for services produce a tax. For example, employers may be able to arrange to sell stock that has little present value, but a large potential value. Employees would have no tax to pay when the potential was realized if they actually bought this stock at its fair market value when it was issued. Nor would they have tax if they did not fully pay for the stock until it reached its higher value. They would owe a tax on the sale of the stock.

Employees cannot avoid a tax on real compensation by purchasing an employer's stock at a bargain. There is a way to avoid tax to the employee—but the employer gets no tax reduction. That is probably had if a stockholder of a company, rather than the company, sold the employees the stock. The employees probably would owe no tax on purchase even though the sale was the act of a stockholder grateful for what the employees had done for his company. But there will probably be a tax if the stock is given as a part of a salary plan or to induce employment.

Special common stock or management common stock is sometimes sold to employees. This may have little or no value when issued or for a long period after, because of restrictions imposed in the negotiations. The stock is then convertible into the ordinary common stock at the end of a stated term and at a predetermined price. It is argued that this conversion produces no tax, even if it gives gain to the holder. This is because exchange of common stock for another class of common stock is not taxed. It is also argued that this conversion of one class of stock into another never produces tax if the arrangement is made for the conversion under the terms of the original issue.

Use of Subsidiary and Management Companies can get Employees Stock Cheaply.

Stock purchase plans often permit investment in newly organized subsidiaries of a company. The features of that system may be—

Stock can be sold cheaply to employees if the new company has little assets and little franchise value. There may be no difficulty with the bargain purchase rules—if we sell at a fair market value. The possibility of employee attention to his investments are greatly enhanced. He will always be interested in building his own estate.

The danger is in creating separate corporations. They may have a value for their franchise. An existing company cannot give up its going concern values to a subsidiary without creating some values. If, on the other hand, your new company is wholly divorced from you and if it does not use your name or facilities then this method might be approved.

Here is a plan announced by a large company to give key employees a stock

interest. It organized a separate new company. It had a capital of $4,000,000. About 5% of this was common stock. The balance of the capital was in interest bearing notes. The employer subscribed to all the stock. It also bought the notes or permitted the subsidiary to sell them to bankers under its guaranty. Key employees were offered stock in the new company at two-thirds of its cost to the employer. That gave them an immediate income and fixed the bargain purchase they made. They agreed—

> To continue working for another year at the same salary. Not to sell the stock without first offering it to other stockholders in proportion to their holdings and then to the new company. To sell to the new company if they enter the employ of a competitor.

The notes (95% of the capital) were to mature in five years. They bore interest at 2½%. At least 50% of each year's earnings of the new company was to be funded to meet the notes. Until the notes were fully paid, the new company's investments were limited to the stock of the employer. This was to be bought on the open market. Eventually, two-thirds of the company will be owned by the employees. If the stock later rises in value, the employees will have built up substantial estates under the employer's credit.

Sometimes management corporations are organized to buy stock for employees. In other variations, the employer-corporation sets up a corporation eventually to be liquidated to its stockholders, this way—

> Organizes the company and invests some of its funds in senior securities. Sells the common stock to employees at nominal value.
>
> Uses the funds invested—or funds borrowed—to buy common stock in the open market; particularly, uses the funds to buy the company's stock when it is selling cheaply or below the net asset value.
>
> Sometimes pays into it bonuses due to employees—instead of direct payments to the men. This may be possible under some stock purchase plans.
>
> Sometimes retires the senior securities held by the employer corporation with the junior securities purchased in the open market. That may be very profitable to the employer-corporation and still more profitable to the employee group.

The employees get what remains when they eventually liquidate the company.

Pre-Career Education

By Thomas W. Byrnes, C.P.A.

The motivating thought which prompted the following lines was to seek the reason for the noticeable omission of names of professional accountants from the lists of corporation directors, trustees, and those appointed to important governmental and civic posts. When an accountant is selected, it is usually done to fill a position requiring his specialized training. It would seem that he is generally a staff rather than a line officer.

A study was made of the curricula of several leading schools of business offering undergraduate courses. In the main, the emphasis was found to be placed on subjects which would aid students later in acquisitive pursuits. And, in the humble opinion of this writer, therein lies the reason: Too much specialization on how to make a living and little or no thought required on how to live.

Dr. Ralph Cooper Hutchison, President of Lafayette College, stated earlier this year:

> "All of the tremendous momentum of education, its research potentialities and its didactic skills should be consecrated primarily to the understanding and the guidance of the thoughts, motives and ideals of men. It would follow that, for the preservation of civilization, for the attainment of human freedom and for the betterment of mankind, men would, in higher education, concentrate on human relations. This would indicate the primacy of the humanistic studies . . ."

Thomas W. Byrnes, C.P.A., has been a member of the Society since 1911 and is a Certified Public Accountant of New York and New Jersey. He is also a member of the American Institute of Accountants. Mr. Byrnes is a consultant to the accounting firm of Byrnes and Baker, C.P.A's. He was formerly an associate professor of accounting at Columbia University.

At least, two other presidents of prominent colleges have shocked freshmen at welcoming exercises by telling them that they would not be taught anything in their undergraduate days which would be productive of income to them. The purpose was, they said, to encourage thinking and to fit the students to get along well with other people.

The narrow specialization of many undergraduate schools of business is largely responsible for the inarticulateness of public accountants on any subject unrelated to business and their apparent unawareness of other happenings in the world about them. That other professional schools encourage a wider diversion of interest was indicated by Dean Wesley Sturges of the Yale Law School when he recently said,

> "The objective of our system is to train lawyers for what they actually do after graduation. Men of the legal profession predominate as directors of private and municipal corporations, churches, universities, and government agencies. The work of lawyers involves much more than strictly legal decisions. To prepare men for being leaders in these various fields we think they should have a broad training in economics, sociology, and psychology as well as law."

The profession of public accounting is comparatively young. The older professions of law and medicine also had to make their impress on the public mind before their members were accorded dignified rating. It required time, and so it will be with public accountancy which has progressed marvelously in the past fifty years. But to obtain the desired recognition it will be necessary to revise the curricula of the undergraduate schools of business in order that more of the liberal arts subjects be included in the required studies. If need be, *intensive* speciali-

zation in business training may then be left to the graduate professional schools.

When the impact of this change becomes evident to the man in the street the public accountant will come into his own and he will be sought after much as his legal co-professional: as an adviser on momentous problems far removed from the specialized field in which he earns his daily bread.

AN ADIRONDACK VIEW

Have you ever lived with artists? We mean the oily kind—the ones who take long, small-handled brushes, squeeze colored paint out of tubes, and daub it around on a piece of canvas.

We have. It happened last spring when we took a week off after Labor Day—March 15th. Darkness was about to be when we arrived at Cambridge, just north of Smuggler's Notch, Stowe, and Mt. Mansfield in Vermont. Application in person was made for admission to the only hotel. Personality, not pull, or perhaps a sense of humor, got us in.

Instead of with skis, the place was littered with oil paintings. Instead of with vigorous snowy-slope maniacs, the place was inhabited with oily-brush maniacs. They, one with wife and children, were there for the hunting season—hunting for snow scenes. None had long hair.

As it must in all village inns, the supper bell rang. We gathered in the dining room, all seven of us, with the stranger in our midst—me, wandering C.P.A. Where did he come from, what did he do to keep the wolf from the door? Here is a write-up of our answer; it won, and paid off with an evening of hearty sociability around the fireplace.

"I'm an artist, a New Hampshire Yankee, now an inhabitant of Saranac Lake; work with black and white only; do pictures for business concerns; no, not their products or buildings. I take a piece of paper and a pencil and, with dollar signs, decimals, and digits, make pictures of businesses. One kind of picture shows business as it stands at a certain date. The bankers call it a financial statement. They correspond to your landscapes.

"Another picture shows the movement of the business for a year. You sell such action pictures to magazines for covers. We call them operating statements. The third kind of picture we make is a command performance, like the post office wall that you have to cover with an appropriate representation. You, too, know about income tax returns, I hope.

"We put a figure here, and a decimal there. Frequently we use both sides of our canvas. We also make the scene as it is now and, alongside, as it was a year ago. Sometimes it's quite a job to make a picture of a business so someone else can understand it when we have only figures to use. Of course some of us use a bit of color once in a while—red. Yeah, I'm an artist too, making good ones, bad ones, and never perfect ones."

Leonard Houghton, C.P.A.
President et al., Adirondack "Chapter".

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

State Tax Dinner

On Thursday, December 4th, 1947, the State Society gave a dinner party in honor of our State Tax officials. Our purpose was to meet more intimately and on a social level the able and excellent men who administer our tax laws.

While there were no formal speeches after dinner, as previously agreed, we did exchange confidences. Alger B. Chapman, President of the State Tax Commission and Deputy Commissioner Emery W. Burton told us of ways in which our Society could cooperate with the State Tax Commission. We were informed that Form 42 C.T., the franchise tax return for real estate corporations, had been revised slightly for 1948, and that form 3 C.T. for 1948 had already gone to the printer and will soon be available to us.

One of the pleasant surprises of the evening was the presence of Rollin Browne who for several years was President of the State Tax Commission and who was responsible for the heroic work that was done in 1944 in changing Article 9A.

Our own State Tax Committee acted as hosts for the evening together with some of the officers of our society. Our president, Simon Loeb, formally greeted our guests and helped make the evening a success. We look forward to further meetings of this kind with our State Tax Administrators.

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University. Mr. Harrow taught accounting at The College of the City of New York from 1919 to 1924. He has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is presently serving on the Society's Committees on Federal Taxation, State Taxation, Cooperation with the State Education Department and Its Agencies, and Cooperation with the Bar. Mr. Harrow is engaged in general practice as a certified public accountant in his own office in New York City.

Form 245 C. T.

Last month we "stuck out our editorial neck" when we suggested that this form need not necessarily be filed every year by those foreign corporations who do not file form 3 CT and who are not doing business within the State. At the dinner our genial deputy, Emery Burton, very graciously took us to task for this. Apparently the Department is not in agreement with the grapevine information I thought I correctly relayed to our members. In the friendly discussion that ensued, Rollin Browne raised an interesting point. He thinks the taxpayer starts the statute of limitations running by filing Form 245 C.T., and that it is therefore to his interest to file this every year. Naturally this form is not required of those foreign corporations that are taxable under Article 9a and that file the regular form 3 C.T.

The Property Factor in the Allocation Formula—Franchise Tax

One of the factors in the allocation of business income or business capital under Article 9A is the property factor. The ratio of real and tangible personal property within New York to real and tangible personal property within and without New York is determined. Aver-

age fair market values are used and only property owned by the corporation is considered.

Property held in New York by an agent or factor is deemed to be situated in New York and if held by an agent or factor outside New York it becomes part of the denominator of the fraction since it is deemed to be located without New York.

Property in transit is considered as not having a situs either within or without the state and is, therefore, omitted both from the numerator and the denominator of the property factor. This applies to property in transit from a point outside New York to a point in New York, or the reverse. If, however, the property is in transit from a point outside New York to another point outside New York it is deemed to be situated without New York. Likewise, if the property is in transit from a point in New York to another point in New York, it is situated in New York. Property ceases to be in transit when it is delivered to the owner or when it becomes subject to actual possession by the owner.

Receipts Factor—Royalties

Royalties from the use in New York of patents are allocated to New York. This poses an interesting question. Just how do you determine that a patent is used in New York? A parent company owns patents and issues a license to a New York company to use the patent. Suppose the patent is on a machine for putting a bottle cap on a bottle. The New York company rents or sells the machine all over the United States. Is the patent being used in New York or within and without New York wherever the machine is used to put the cap on the bottle? If the latter, may the New York company allocate its income or its tangible personal property on the basis that its property is being used within and without New York and, therefore, there is a place of business wherever the property is used outside New York? By the same token are not the royalties of the parent company receipts from the use of the patent within and without New York? It should be noted that if the parent company is deemed to be doing business in New York it will be taxed on all income from royalties even though these are derived from a subsidiary. Royalties are not included as subsidiary income but are business income, so that even though subsidiary income is excluded from entire net income subject to tax, the exclusion does not cover royalties. A combined return would not help the situation since in determining entire net income the deduction from gross income of royalties paid by the subsidiary company is eliminated by the intercompany income of the same item received by the parent company.

The regulations (Art 413 (4)) say that a patent is used in New York to the extent that activities thereunder are carried on in New York. If such activities are of an interstate character, and they usually are in this type of situation, a corporation should be entitled to an allocation even though it does not technically have a regular place of business outside the state. In spite of the authority given to the State Tax Commission under the law to use some other formula which will accurately reflect the business activity in New York, it will not consider any allocation of business income unless the corporation does have a regular place of business outside the state.

Payroll Factor in the Allocation Formula

This factor in the allocation formula is the ratio of wages, salaries, and other personal service compensation paid to employees within New York to the total amount of such compensation within and without New York. Compensation to general executive officers is eliminated both from the numerator and denominator of this fraction.

Generally a New York employee is considered one who is connected with or works out of an office maintained by the taxpayer in New York, even though

actual services are performed without New York. This treatment to be sure weighs the tax in favor of New York. The Tax Commission realizes that the result would not be equitable if a substantial part of the payroll covers employees attached to a New York office who perform a substantial part of their services outside New York. Therefore, in such a case it permits the payroll factor to be computed on the basis of services actually rendered within and without the state. If the regular rule weighs the tax against New York because a substantial part of the payroll covers employees attached to offices outside the state who nevertheless perform a substantial part of their services within New York, the Commission will likewise require such payroll allocated on the basis of services performed within and without the state. In this type of situation the Commission will determine the services performed within or without the state on the basis of the method employed in compensating the employee. Where the employee is paid according to the volume of business done, the amount received for such business done in New York is allocated to New York. A salesman on a commission basis would come within this category. If compensation depends upon results achieved, the value of services within New York is allocated to New York. If an employee is compensated on a time basis, the allocation to New York is based upon the working time within New York.

The payroll factor is concerned with compensation to employees, except general executive officers. The regulations therefore indicate the scope of the term as covering any person over whom the employer has the right of control and direction both as to the result to be accomplished and also the means by which the result is to be accomplished. This is a familiar definition of employee. If the relationship exists, the designation of the employee is immaterial and likewise the method or measure of compensation. A director of a corporation is not an employee and director's fees are not includible in computing the payroll factor.

Inventories

The Committee on Accounting Procedure recently issued Bulletin No. 29 on Inventory Pricing. This subject is of special interest at this time first because the presentation of financial statements requires a sound knowledge of the accounting principles relating to the valuation of inventories especially in a period of rising prices. Secondly, the valuation of inventories vitally affects the taxation of net income. It is a basic principle of taxation that income must be realized through a completed transaction before it is subject to tax. In the case of inventories this principle is disregarded in that a loss effectually may be taken to reduce gross income where the inventory has dropped in value. Under the tax laws the taxpayer may value his inventory at the lower of cost or market, thus taking the loss into account even though there has been no realization of it through a sale. In a real sense there is a resulting distortion of income as between two accounting periods, since the true basis for a loss must be cost. To be sure this principle of valuation has the sanction of sound accounting practice and it is acceptable also under our tax laws.

A review of some of the tax principles in relation to the valuation of inventories is appropriate at this time. Where inventories are a factor in the determination of income, a taxpayer may not ignore them. That means that he must under these circumstances report his income from a business on an accrual basis, even though he is otherwise on a cash basis. Under Section 356 of the law the Commission may prescribe the basis upon which inventories shall be taken. The law further prescribes that this basis shall conform to the best accounting practice in the business and that it shall most clearly reflect income. The regulations (Article 216) add that inventories are necessary

in a business that produces, purchases or sells merchandise. The inventory must include raw materials and supplies on hand and also finished goods and work in process owned by the taxpayer. Ownership depends upon the vesting of title, so that a seller includes in his inventory goods under contract for sale but not yet segregated and also goods out upon consignment. If title to merchandise has passed to a purchaser he includes such merchandise in his inventory even though it is still in transit.

Valuation of Inventory

The regulations reiterate the law that the valuation of an inventory must conform to the best accounting practice in the business and must clearly reflect the income. Trade customs in a particular trade are emphasized rather than uniform rules for all businesses. Greater weight is given to consistency rather than to any particular method. Significant are these words: "An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income."

The most common method of valuation is cost or the lower of cost or market. Unsalable goods or goods unusable because of damage, imperfections, shop wear, changes of style, odd or broken lots, and second hand goods taken in exchange should be valued at bona fide selling prices less cost of selling, even though the basis of valuation is otherwise cost or the lower of cost or market. If the unsalable or unusable goods consist of raw materials or work in process held for use or consumption they are to be valued upon a reasonable basis, but in no case may they be valued at less than scrap value.

While this gives a taxpayer considerable leeway the regulations define bona fide selling price as actual offering of goods during a period ending not later than 30 days after inventory date. The taxpayer has the burden of proving that goods so valued come within the category of unusable goods. The taxpayer is also required to maintain records of the disposition of such goods so that a verification of the inventory can be made.

Having once exercised the option of adopting the cost basis or the lower of cost or market basis of inventory valuation, a change for subsequent years may be made only upon permission from the State Tax Commission. If items in an inventory cannot be identified with specific invoices they will be deemed to be goods most recently purchased or produced (applying the first-in, first-out rule). As an alternative method the taxpayer may employ an average cost basis if he maintains book inventories in accordance with a sound accounting system. Balances shown by such book inventories are required to be verified by physical count at reasonable intervals. While there is no special authorization of the use of the Lifo method now sanctioned by the Treasury Department it is believed that such method would be acceptable to the Tax Commission.

Taxpayers are cautioned that inventories should be preserved as a part of the accounting records, that such inventories will be subject to investigation by the Tax Commission and that the taxpayer must satisfy the Commission of the correctness of the prices adopted.

Certain practices are specifically proscribed as unacceptable.

1. A deduction of a reserve for price changes or for estimated depreciation.
2. Taking work in process at a nominal price or at less than its proper value.
3. Using a constant price or nominal price for a so-called normal quantity of goods in stock.
4. Including stock in transit to which taxpayer does not have title.
5. Omitting portions of the stock on hand.

Real Estate Corporations

The real estate company is classified separately for franchise tax purposes. It is taxed under Art. 9, Sec. 182, and the rate of tax is considerably less than the rate applicable to business companies. It is therefore important, particularly in close situations, to be prop-

erly classified as either a business corporation taxable under Article 9A or a real estate corporation taxable under Article 9. Sec. 182 defines corporations that may be classified as real estate corporations, and this definition includes a corporation that leases real property under a leasehold for a term of twenty years or more and under the terms of the leasehold is required to pay the real estate taxes.

The Franchise Tax return, form 42 CT, requires the corporation to answer a series of questions for the purpose of determining whether the corporation is properly to be classified as a real estate company. With respect to leaseholds question 9(d) asks, "Does this corporation hold any property under a leasehold of twenty or more years duration? If so, state terms as to length of lease and payments of real estate taxes." The duration of a lease is figured from the effective date of the leasehold. If the leasehold is not for a full twenty years the corporation is classified as a business corporation taxable under Article 9A.

The rate of tax is one fourth of a mill on each dollar of the full value of the gross assets employed within the state. Schedule F of Form 42 CT requires a listing of the real estate held during the year showing the purchase price and assessed valuation. One of our members asks this question: If a corporation holds only a leasehold of twenty years duration for the acquisition of which it did not pay anything, is such leasehold to be valued as a gross asset subject to tax? The leasehold is not includible in Schedule F since it does not constitute real estate. But the tax is based upon the full value of all gross assets and the balance sheet required to be submitted on page 2 of Form 42 CT indicates the assets. Even if the leasehold is not included as an asset on the balance sheet, question 9 does divulge the existence of the leasehold. It is possible to value a leasehold of this type, probably on the basis of net income and it is the opinion of the editor that the Tax Commission would set a value on the leasehold and include it in the basis for the tax.

Franchise Tax—Fiscal Year

A corporation received its charter on February 26, 1946. It did not commence operations until several weeks later. The directors adopted a fiscal year beginning March 1, 1946, and ending February 28, 1947, and filed its first federal income tax return and a state franchise tax return for that period. The State Tax Commission claimed that a franchise tax was due and payable for the period from February 26, 1946, to February 28, 1946, a period of two days. For a business corporation the minimum tax would be $25. The Commission is correct. The franchise tax is for the privilege of exercising a corporate franchise. The basis is a calendar or fiscal year or any part thereof. In this case the tax for being a corporation for two days might have been avoided if the first fiscal year had been for the period ending January 31, 1947.

Real Estate Corporation—"Dummy" Corporations

There is a specific section of the law (Sec. 12 (1)) dealing with corporations that hold only the record title to real estate but which otherwise do no business. This section provides that such a corporation shall be deemed to be the absolute owner of such real estate and subject to franchise tax. Furthermore the profits from the rental or sale of such property is deemed to be profits of the corporation. The fact that such stockholder is receiving the income means that the stockholder has received a dividend of the amount retained by him. Such dividend is of course subject to the 2% tax against the corporation. It should be further noted that the lien for franchise taxes attaches to such property.

This treatment of "dummy" corporation is radically different from the federal income tax treatment, where the corporate entity may be entirely ignored.

**Real Estate Corporation—
Additional Tax on Dissolution**

Sec. 182 (a) provides that upon dissolution, merger, or consolidation the corporation shall be subject to the additional tax of 2% on surplus available for distribution at the time of liquidation, merger, etc. In determining the surplus actual values of assets are used. One of our members points out that in determining the surplus the Commission does not reduce the surplus by the additional tax on that surplus, which obviously will result in a lesser amount to be distributed. Our member is undoubtedly correct. However the mathematically correct result requires a computation involving two unknown figures. As a practical matter the Tax Commission might object to such a solution of the problem. This editor would like to see the situation presented to the Commission with the correct result worked out by the accountant. It is our opinion that the Commission would accept the tax so computed. There would not appear to be anything in Sec. 182(2) to prevent a literally accurate method of computing surplus available for distribution.

**Real Estate Corporations—
Loans to Stockholders**

To be taxable under Sec. 182 a corporation must be wholly engaged in the purchase and sale of real estate or hold title to real estate. The question often arises as to the extent to which such a corporation may be engaged in other activities. Sec. 182 provides that a real estate corporation will not lose its classification as such if not more than 10% of its average gross assets, at full value, consists of stocks, bonds or other securities, or loans to wholly owned real estate subsidiaries. Loans to stockholders are not within this category and such loans even though within the 10% requirement would jeopardize the classification of a corporation as a real estate company. Furthermore a loan to a stockholder might be construed as an informal dividend distribution, particularly if the corporation has a surplus, and the loan might be subject to the additional tax of 2% on dividends.

Accounting at the S.E.C.

Conducted by WILLIAM W. WERNTZ

IN a recent address before the 22nd Annual Accounting Conference at the University of Michigan, Earle King, Chief Accountant, outlined the present status of the long standing controversy as to whether unusual, nonrecurring, and extraordinary items should or should not be reflected in the income statement. His own views he stated thus:

"My own thoughts in the matter are influenced by a belief that if we can reach a general acceptance of the view that all elements of profit or loss recognized during the period must be included in the profit and loss statement for the period, thus banning any debits and credits to earned surplus for these items, we will attain a more carefully considered periodic report than under the other procedure which permits correction of this year's errors—particularly errors in judgment—to be reported through earned surplus in subsequent years. The many corporate actions that follow from the year's determination of income, such as bonus and dividend payments, compliance with terms of contracts and indentures and so on, are additional reasons for adhering to the historical or all-inclusive profit and loss statement. It is contended that exceptions are inevitable in the application of this method. Lump-sum write-off of goodwill or other intangibles is given as a common example. If the problem is faced squarely, I think a sound program of amortization through profit and loss can be developed to cover these cases and thus avoid the lump-sum treatment. The problem of over-generous provisions for losses through excessive charges to profit and loss can be met by more careful determination of the appropriate amounts to be considered in the determination of income and the expression of conservatism through appropriation of surplus to general contingency reserves or by recognizing that earned surplus is in fact an all-purpose reserve to be guarded by conservative financial management. Such a program, I sincerely believe, would retain for the accountants the confidence of investors and other users of financial statements more surely than a program which would permit the annual revision of published profit and loss statements."

From his remarks it appears that the Commission, though leaning toward the all-inclusive income

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Mr. Werntz is the author of numerous articles which have appeared in technical accounting publications. He is Vice-President of the American Accounting Association.

statement endorsed by the American Accounting Association, is not yet prepared to take exception to the view that unusual items of sufficient size to distort the income statement may or should be carried directly to surplus. This view, he says, is taken in a draft of a proposed bulletin on the subject now under consideration by the Committee on Accounting Procedure of the American Institute of Accountants. In describing probable Commission policy in the near future, he states:

"This apparently irreconcilable divergence of views between the spokesmen for the American Accounting Association and the American Institute of Accountants on a question of accounting of such fundamental importance is most disturbing to me; for it is to such bodies of professional accountants that the Commission looks for the authoritative statement of accounting principles which may be regarded as generally accepted.

"While the accounting staff of the Commission has been, for many years, fully in accord with the views of the Association as quoted above and has lent its support to their general adoption, in view of the widespread disagreement on the subject among practicing public accountants and the convincing arguments advanced in support of both sides of this question we have not felt it desirable to freeze our views by recommending to the Commission the adoption of a rule on the subject. Instead it seems desirable to observe the effects of the proposed bulletin (if it is issued in its current form) in practice for a reasonable period, and in the meantime to accept either treatment offered on the grounds that each has substantial authoritative support. It may be that, as some of the proponents of the proposed bulletin intimate, supportable entries direct to surplus will be so rare under the provisions of the bulletin that the results will be acceptable. If this proves to be the case, it will be a long step forward in the development of comparable profit and loss statements; for analyses we have made have indicated a lack of uniformity in this field between industries, companies in the same industry, and clients of the same accountants."

The Taxpert

The Taxpert Serves "Stewp"

By Lewis Gluick, C.P.A.

The French have a national dish called *pot au feu.* Literally translated it means "pot on the fire". Today the French, like all other Europeans, are on short rations. But in the best of times they were thrifty people, and waste was abhorrent to them. On the stove was kept a large pot into which went all (and from what we have been told, it was *all*) scraps of food, not otherwise usable. Periodically the grease would be skimmed off, and the result served as a sort of soup, or stew. Mrs. Gluick is partly French on her mother's side, and has an instinct for good cooking, which she has developed to a high degree. One of her best concoctions is the American descendent of *pot au feu,* which she calls "Stewp" (Stew plus soup, if you must have a diagram). It does not accumulate in a pot on the gas range. The ingredients accumulate, each in its separate glass container, in the icebox, until there are enough for a meal. And what a meal! With a little lettuce from the garden, and some bread, it makes a thoroughly balanced ration, economical and delicious. Herewith the writer serves up some tax "Stewp" which has been collecting in his files.

* * *

We have all heard much of "the law's delays" but the case of *Union Bleachery* must approach a record. This decision of the United States Court for the Western District of South Carolina was handed down on August 14, 1947. The opening statement of the opinion is: "This action was instituted October 23, 1933". The taxable years involved start with 1923. And there are still the Circuit and Supreme Courts to go! (47-2 USTC ¶9354)

* * *

A couple of Shoptalkers with whom we lunched raised a neat technical point that will have to be decided soon. Will the Commissioner please issue a ruling? By Congressional action, war amputees may be provided a special auto, cost not exceeding $1,600, adapted to their infirmities. They are not permitted to sell the car for two years. Question: when and if sold, will the proceeds be taxable, on the zero cost theory; or will they be treated as a taxfree pension or allowance?

* * *

We heard George Altman discuss *"What is 'Market'?"* briefly at a Los Angeles C.P.A. luncheon. Regulations 111, article 22(c)4 are not explicit as to how "market" shall be determined. Each case must be determined on its factual evidence. Experience, says Altman, indicates that actual sales within not more than thirty days after inventory date, at the "market" price, will justify the price. But such sales must be bona fide, and not isolated transactions and of small quantities. Public offerings, whether by newspaper advertising, window displays or bargain counter signs, are good evidence.

* * *

Below is a quirk in community property. We already have told you

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that community property is not always an advantage taxwise.

John and Mary have a young daughter, Helen. John's salary of $6,000 per year is the only family income. Helen requires an operation, the total costs of which are $750. Question, what is the deduction under section 23(x)?

At first glance almost anyone would say, each spouse takes $375 less $150 (which is 5% of $3,000), or a net of $225 medical deduction. On the contrary, only John gets the deduction. The reasoning (we won't call it logic) of the Commissioner runs this way: (1) Medical deductions may be taken only by the person paying the costs; (2) Such deductions can only be taken for dependents. There is only one dependent. John takes her. Therefore John alone gets the medical deduction. Seems unfair, but that's the way it is.

However, let's make a calculation to see if anything can be salvaged. Assume that other allowable deductions total only $100. Obviously, medical deductions aside, tax should be computed under Supplement T. This would give each spouse a deduction of $302.50. So by using the tables, the couple can get $505 of the medical expenses.

* * *

Travel or Medical?

We quote a summary of the case of *Bruton* 9TC, No. 117:

"Taxpayer, a practicing lawyer, suffered a partial paralysis, as the result of which he could not use public conveyances in going to and from his office. He engaged taxicab service, which was the least expensive form of practical transportation, and claimed the amounts paid for taxicab fares as deductions in his income tax returns for 1942 and 1943. On the finding that such expense was necessitated by the taxpayer's physical condition, rather than by reason of his business, the Tax Court held that it is not deductible as a business expense."

We deem this good law. We believe, however, that if the taxpayer had included his taxi fares as part of the medical costs allowable under Section 23(x) of the code, he might have won his case. His expense stemmed directly from his illness. If he had not used taxis, he would have had no taxable income at all. What the Treasury wants is taxable income. No income, no public revenue.

PROFESSIONAL COMMENT

By EMANUEL SAXE, C.P.A.

Some Personal Observations Upon the Advent of the New Year

It is almost two years, now, since the present editor assumed responsibility for the publication of this magazine. For a few months in the beginning, plans were on a virtual day-to-day basis: the manuscript larder was bare and new articles had to be solicited, received, edited, and published within the time limits of an inexorable deadline. For some time and until a satisfactory backlog of suitable material had been amassed, planning for changes in and additions to the magazine was simply out of the question. Fortunately, this situation is now a thing of the past, and we hope that our readers have observed some progress toward an improved publication during the past year.

Several new and interesting "Departments" have been added as a regular monthly feature. An attempt has been made to have each issue revolve around a limited number of topics. The format of the outside cover has been changed so as to enable the reader to perceive the central themes of the issue at a glance; likewise, the arrangement of the "Table of Contents" page has been conformed, to permit of the quick recognition and selection of individual articles. It has been our policy, wherever possible, to publish original articles considered to be of interest and help to our members. Debate regarding the ideas expressed in them has been encouraged in our "Correspondence" section. Current professional thinking and writing, as reported in other forums, has been promptly summarized and reported in these columns. And everything in each volume has been carefully indexed and the index made a part of the last issue of each year.

While the editor has always had the continuous help and extremely valuable support of the members of the Editorial Board in the accomplishment of these improvements, nevertheless, during this entire period not one communication was ever received from any reader by way of his reaction to any of these changes! As an accountant, your editor has necessarily inferred your assent from this negative form of confirmation, but he really would prefer a positive reaction from our readers. This magazine is published primarily for you and, unless it helps to satisfy your professional needs and meets with your approval, it is not fulfilling its purpose.

Will you help us to evaluate our policies and in our planning for the future, by taking just a moment *now* to drop us a note indicating your reactions to the changes which have taken place in the magazine, and including whatever suggestions for the further improvement thereof that you may care to make? We will be deeply appreciative.

* * *

Offsets to the Medical Expense Deduction under IRC, Section 23(x)

The Tax Court recently handed down a decision in a case of first impression, which may be of considerable interest to members covered by the Society's group insurance contract or by similar policies. (Deming v. Commissioner; 9TC No. 56; September 23, 1947)

The facts were these: The petitioner was struck by an automobile on November 13, 1941, and sustained injuries which confined him in a hospital for approximately six weeks and required

medical treatment and care for the entire year 1942. During 1942, the petitioner expended $2,117.90 for medical expenses, including hospitalization, doctors' bills, nurses, and medicines. The petitioner was insured against accident by each of three companies, whose policies were of the standard form of personal accident insurance. They provided (*inter alia*) for payments of stipulated sums for loss of life or limb; weekly indemnity for total disability and/or partial disability; double indemnity; *specified hospital and graduate nurse indemnity;* and *specific surgical indemnity* (emphasis supplied). The insurance companies paid the petitioner $7,011.66 during 1942, determined and classified as follows: Total weekly indemnity for disability—$6,160.00; and total payments for hospitalization and medical expenses—$851.66. Upon trial of the issue by The Tax Court, the petitioner conceded the propriety of excluding the amount of $851.66 from the deductions under IRC Sec. 23 (x), but claimed the amount of $747.56 ($2,117.90 minus $851.66 or $1,266.24, reduced by $518.68 (5% of taxpayer's net income) or $747.56) as a proper deduction thereunder.

The respondent Commissioner disallowed the deduction on the ground that it was fully compensated for by insurance or otherwise within the meaning of IRC sec. 23(x) because, during 1942, petitioner received compensation totaling $7,011.66 under personal accident insurance contracts.

The Court held that expense for medical care compensated for by insurance which is *not* to be allowed as a deduction under section 23(x) means that the insurance payments received as compensation must necessarily have been upon the risk of such medical expense as are deductible under the section, and *not* upon any other risks such as were contained in the policies involved in the instant case. The Court further held that the first clause of IRC Section 22 (b) (5), as amended by section 127 (d) of the Revenue Act of 1942, did not affect the result since this section merely provides that "amounts received through accident or health insurance . . . as compensation for personal injuries or sickness" are to be excluded from gross income, "except in the case of amounts attributable to (and not in excess of) deductions allowed under section 23(x) in any prior taxable year." Said the Court, ". . . (the) latter section, standing alone, provides the criteria for determining what amounts are deductible in any particular year on account of medical expenses."

* * *

"Direct Cost" Method for Valuing Inventories

Some months ago, in March, 1947, this department had occasion to review a paper by Philip Kramer entitled, "Selling Overhead to Inventory", which appeared in the January 15, 1947, issue (Section One) of the N.A.C.A. Bulletin. Therein, we analyzed his argument in favor of omitting fixed manufacturing overhead costs from inventory valuation.

More recently, A. R. Kassander, of the New York Office of Lybrand, Ross Bros. & Montgomery, had occasion to publish his views on the same subject in the September, 1947, issue of the L.R.B.&M. Journal. Following a very careful analysis, Mr. Kassander concluded as follows:

> "All accounting principles must be applied in a manner which gives due consideration to all the circumstances surrounding the concern and type of operation under examination. It may be that under a given set of conditions the direct cost method will produce financial statements which best reflect a company's financial position and results of its operations. The author concludes, however, that for manufacturing business in general there is little if any advantage in changing to the direct cost method for valuing inventories and that the proposed method may, in fact, result in loss of significant managerial information."

* * *

Installing Manual Fixed Asset Records

Donald R. Thompson, Secretary and Controller of The Snow-Nabstedt Gear Corporation, New Haven, Conn., reports upon the manner in which his firm recently accomplished the installation of a property record system which included a complete plant ledger. (N.A.C.A. Bulletin, Section One, November 15, 1947)

The reasons motivating the decision to effect this installation are given, as follows:

1. The need for supporting detail with respect to capital investment accounts.
2. The basis for more accurate depreciation charges and consequent effect on cost of operations.
3. A more accurate basis for determining insurable values and for substantiating claims for losses sustained.
4. A sounder basis for tax returns, both income and property.
5. One portion of the basis for a production control system.
6. Dependable basis for entries reflecting the retirement and sale of plant assets.

The plan was carried out in the following stages, which are completely discussed in the text of the article:

1. Prepare a per books inventory of capital assets by accounting classification at cost, and show the portion of the depreciation reserve applicable to each asset at the end of the preceding fiscal year.
2. Take a physical inventory of capital assets by accounting classification and show machine numbers, maker's numbers, and other pertinent data.
3. Reconcile the book and physical inventories.
4. Adjust differences between book and physical inventories by write-off or transfer of assets among classifications.
5. Number all machines.
6. Post and balance the new records and prepare master lists.

Mr. Thompson concludes as follows:

"Plant records are a logical product of a company's growth. If they are installed in the early stages of the growth period they can be set up fairly easily. Later they may pose almost insurmountable difficulties."

* * *

Variable Budgets in the Control of Costs

Thomas D. Foy, Supervisor of Cost Reduction of the Apparatus Manufacturing Division of General Electric Company, Schenectady, N. Y., has presented an interesting article in Section One of the November 1, 1947, issue of the N.A.C.A. Bulletin, which is "devoted principally to certain areas of one application of variable budgeting."

The concept of flexible budgeting is first presented generally through the medium of a simple, illustrative break-even chart. Next, a method of determining fixed and variable expense elements without the use of graphs is demonstrated. The balance of the paper covers:

"(1) the ready approach to control afforded by a flexible budget once prepared,

(2) the problem of control of indirect manufacturing expense, which contains the largest number of mixed fixed-variable items, and

(3) the special use of variable budgeting in attempting to prepare for the uncertain future of business activity."

Mr. Foy believes that the flexible budget is the best possible means of effecting the "rapid adjustment of cost elements to all production levels which outside conditions may force."

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